No. 92-1839-CSX
Status: GRANTED

Title: Colgate-Palmolive Company, Petitioner
v.
Franchise Tax Board of California

Docketed:
May 19, 1993

Court: Court of Appeal of California,
Third Appellate District

Counsel for petitioner: Kleier,James P.

Counsel for respondent: Schell,John D., Land,Claudia K.

021893 Sup Ct CA den review

Entry	Date	Note	Proceedings and Orders
1	Apr 28 1993	D	Application (A92-824) to extend the time to file a petition for a writ of certiorari from May 19, 1993 to July 18, 1993, submitted to Justice O'Connor.
2	May 3 1993		Application (A92-824) denied by Justice O'Connor.
3	May 19 1993	G	Petition for writ of certiorari filed.
5	May 28 1993		Order extending time to file response to petition until July 17, 1993.
6	Jul 16 1993		Brief of respondent Franchise Tax Board of California in opposition filed.
7	Jul 19 1993	G	Motion of Committee on State Taxation, et al. for leave to file a brief as amici curiae filed.
8	Jul 19 1993	G	Motion of Tax Executives Institute, Inc. for leave to file a brief as amicus curiae filed.
10	Jul 21 1993		DISTRIBUTED. September 27, 1993
11	Aug 2 1993	X	Reply brief of petitioner filed.
12	Oct 4 1993		Motion of Committee on State Taxation, et al. for leave to file a brief as amici curiae GRANTED.
13	Oct 4 1993		Motion of Tax Executives Institute, Inc. for leave to file a brief as amicus curiae GRANTED.
14	Oct 4 1993		Motion of Tax Executives Institute, Inc. for leave to file a brief as amicus curiae GRANTED.
15	Oct 13 1993		REDISTRIBUTED. October 29, 1993 (Page 13)
16	Oct 18 1993	X	Supplemental brief of petitioner filed.
17	Nov 1 1993		Petition GRANTED.
			**********
18	Dec 15 1993		Brief amici curiae of National Foreign Trade Council, Inc., et al. filed.
19	Dec 15 1993		Joint appendix filed.
20	Dec 15 1993		Brief of petitioner Colgate-Palmolive Co. filed.
23	Dec 15 1993		Brief amicus curiae of Committee on State Taxation filed. VIDED.
24	Dec 16 1993		Brief amici curiae of Chamber of Commerce of the United States of America, et al. filed.
25	Dec 21 1993	G	Motion of petitioners for divided argument filed.
26	Jan 10 1994		Motion of petitioners for divided argument GRANTED.
27	Jan 14 1994	G	Motion of California Legislature for leave to file a brief as amicus curiae filed.
38	Jan 14 1994	D	Motion of Government of the United Kingdom for leave to participate in oral argument as amicus curiae, for divided argument and for additional time for oral

No. 92-1839-CSX

Entry	Date	Note	Proceedings and Orders
			argument filed.
39	Jan 14 1994	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
28	Jan 19 1994		Brief amicus curiae of United States filed. VIDED.
29	Jan 19 1994		Brief amicus curiae of Citizens for Tax Justice filed. VIDED.
30	Jan 19 1994		Brief of respondent Franchise Tax Board of California filed.
31	Jan 19 1994		Brief amicus curiae of Multistate Tax Commission filed. VIDED.
32	Jan 19 1994		Brief amici curiae of Council of State Governments, et al. filed. VIDED.
33	Jan 19 1994		Brief amici curiae of North Dakota, et al. filed. VIDED.
34	Jan 19 1994		Brief amici curiae of California Tax Reform Association, et al. filed. VIDED.
35	Jan 19 1994		Brief amici curiae of Alaska, et al. filed.
36	Jan 19 1994		Brief amici curiae of Litton Industries, et al. filed.
37	Jan 19 1994		Brief amici curiae of New Mexico, et al. filed. VIDED.
40	Jan 19 1994		Brief amici curiae of Byron L. Dorgan, et al. filed. VIDED.
43	Jan 19 1994		Brief amici curiae of Don Edwards, et al. filed. VIDED.
41	Feb 2 1994		SET FOR ARGUMENT MONDAY, MARCH 28, 1994. (3RD CASE).
42	Feb 4 1994		CIRCULATED.
44	Feb 14 1994		Opposition of petitioner Barclays Bank to motion of California Legislature for leave to file a brief as amicus curiae filed.
45	Feb 16 1994		Opposition of petitioner Colgate Palmolive Co. to motion of California Legislature for leave to file a brief as amicus curiae filed.
46	Feb 18 1994	X	Reply brief of petitioner Colgate-Palmolive Co. filed.
47	Feb 22 1994		Motion of California Legislature for leave to file a brief as amicus curiae GRANTED.
48	Feb 22 1994		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
49	Feb 22 1994		Motion of Government of the United Kingdom for leave to participate in oral argument as amicus curiae, for divided argument and for additional time for oral argument DENIED.
50	Feb 22 1994		Record filed.
		*	Original proceedings Superior Court, Sacramento (COLGATE - BOX)
51	Feb 25 1994		Record filed.
		*	Original proceedings Court of Appeal of California, Third Appellate District. (COLGATE - BOX)

92-1829

No. 92-

Supreme Court, U.S.
FILED
MAY 19 1993
OFFICE OF THE CLERK

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1992

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

Petition For A Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

PETITION FOR A WRIT OF CERTIORARI

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

Counsel for Petitioner

QUESTIONS PRESENTED

1. Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant Commerce Clause, may be found in congressional silence.

2. Whether worldwide combined reporting as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the Foreign Commerce Clause.

LIST OF PARTIES

The parties are as stated in the caption.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, petitioner states that Colgate-Palmolive Company has no parent corporation. Its non-wholly owned subsidiaries are listed in the Appendix to this petition at App. G at 104a.[1]

[1] All references to the Appendix in this petition are denominated "App." followed by a unique letter assigned to each item and a page reference.

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IN THE

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OCTOBER TERM, 1992

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COLGATE-PALMOLIVE COMPANY,

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An Agency of the State of California,

Respondent.

Petition for a Writ of Certiorari to the Court of Appeal of the State of California In and for the Third Appellate District

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the California Court of Appeal is reported at 10 Cal. App. 4th 1768, 13 Cal. Rptr. 2d 761 (3d Dist. 1992) (App. B at 2a-26a). An earlier opinion of the Court of Appeal in the same case was reported at 233 Cal. App. 3d 855, 284 Cal. Rptr. 780 (3d Dist. 1991) (App. E at 29a-73a). The opinion of the California Superior Court (App. F at 74a-103a) is unreported.

JURISDICTION

The judgment of the California Court of Appeal, Third Appellate District, was entered on November 20, 1992. App. B at 26a. The California Supreme Court denied review on February 18, 1993. App. A at 1a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article 1, section 8, clause 3 of the United States Constitution, the Commerce Clause, U.S. Const., art. I, § 8, cl. 3, provides: "The Congress shall have power ... [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

California Revenue & Taxation Code, Cal. Rev. & Tax. Code § 25101 (West 1992) provides: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). ..."

STATEMENT

This case, like *Barclays Bank Int'l Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 8 Cal. Rptr. 2d 31, 829 P.2d 279 (1992), *on remand*, 11 Cal. App. 4th 1678a (3d Dist. 1992), *petition for cert. filed sub nom. Barclays Bank PLC v. Franchise Tax Bd.*, 61 U.S.L.W. 3621 (U.S. Feb. 22 1993) (No. 92-1384), raises issues of profound national and international significance regarding the states' power to require multinational corporations to report their income on a worldwide combined basis.[2] Specifically, this case raises the question whether Congress, by its silence, may be taken to have consented to the states' use of worldwide combined reporting, thereby precluding any inquiry into its constitutionality under the dormant Commerce Clause; and, if not, whether worldwide combined reporting frustrates federal foreign policy in violation of the Commerce Clause. The petitioner in *Barclays* raises these questions in the context of a group of foreign and domestic corporations with a foreign parent (a foreign-based multinational group), while this case involves the same questions in the context of a group of foreign and domestic corporations with a domestic parent (a U.S.-based multinational group). The facts regarding these questions, which have been stipulated, are not in dispute.

1. Colgate-Palmolive Company's Business

Colgate-Palmolive Company is a Delaware corporation with its corporate headquarters in New York. During the years in question, 1970-73, Colgate-Palmolive Company and its subsidiaries doing business in the United States (hereinafter "Colgate"), were engaged principally in the manufacture and distribution of household and personal hygiene products. Colgate's operations extended throughout the United States, including California, where it manufactured and sold products. In addition to its United States operations, Colgate owned approximately 75 foreign subsidiaries that operated in 53 foreign countries.[3] Joint Stipulation, *Colgate-Palmolive Co. v.*

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[2] Another certiorari petition recently filed in this Court also raises these issues. *Alcan Aluminum Corp. v. Franchise Tax Bd.*, No. 2 Civ. B 065848 (2d Dist. Cal. 1992) (unpublished decision), *petition for cert. filed*, 61 U.S.L.W. __ (U.S. May 3, 1993) (No. 92-1751).

[3] Colgate does not challenge here the trial court's conclusion that Colgate was engaged in a worldwide unitary business with its foreign subsidiaries other than certain subsidiaries acquired in 1972 and 1973.

Franchise Tax Bd., No. 319715 (Cal. Super. Ct.) at ¶ 8.[4] These foreign subsidiaries, which were likewise engaged in the manufacture and distribution of household and personal hygiene products, operated *exclusively* in countries outside the United States. They conducted no business in California or in any other state and sold no products in California or any other state.

2. The Separate Accounting Method

The United States, along with the majority of other nations of the world, uses the "arm's-length" or "separate accounting" method to allocate the income of a multinational group among the different jurisdictions in which it operates.[5] Under this method, the various members of a multinational enterprise are viewed as separate from one another, and the income of any particular member of a group is determined on the basis of the internal accounting records of that member. Affiliates are required to report intercompany transactions on an arm's-length basis, as if dealing with unrelated entities in the marketplace. Separate accounting is the method uniformly adopted in tax treaties between the United States and foreign nations, as well as the standard that the United States has adopted in its internal tax laws.[6]

3. California's Taxing Scheme

California's worldwide combined reporting method of taxation (Cal. Rev. & Tax. Code § 25101) treats as a single enterprise all of the worldwide affiliates of a multinational group that are engaged in a unitary business. The resulting worldwide income is apportioned between California and the rest of the world based on a three-factor formula of property, payroll and sales. Thus, for the years in question, Colgate's California property was divided by the worldwide property of Colgate and all of its foreign subsidiaries. Similar worldwide fractions were obtained for payroll and sales. The average of the three was then applied against the worldwide combined taxable income of Colgate and all of its foreign subsidiaries to apportion part of it to California.

[4] All subsequent references to the Joint Stipulation in this case are denominated "Stip." followed by a paragraph reference.

[5] *See* 26 U.S.C. § 482.

[6] *See* Treasury Department's Model Income Tax Treaty of June 16, 1981, arts. 7(2), 9(2), *reprinted in* 1 Tax Treaties (CCH) ¶ 211 (1992); OECD Model Convention for the Avoidance Of Double Taxation with Respect to Taxes on Income and Capital, arts. 7(2), 9(1), (1992), *reprinted in* 1 Tax Treaties (CCH) ¶ 201 (1992). *See also* 26 U.S.C. § 482.

4. Opposition to California's Taxing System

Since its inception, California's use of the worldwide combined reporting method of taxation has been the focus of steadily increasing national and international opposition because of its disregard of the established international norm of tax accounting. On the international front, foreign governments have repeatedly protested California's use of the taxing method.[7] Indeed, its continued use prompted the United Kingdom, in 1985, to enact retaliatory legislation.[8] This legislation gives the United Kingdom the authority to deny the shareholders' tax credit (a credit that the United Kingdom gives on dividends paid by U.K. subsidiaries to their U.S. parents) to U.S. parent corporations with a presence in states that

[7] *See, e.g.*, Statement of the United Kingdom before the United States Treasury Working Group on Worldwide Unitary Taxation, Stip. ¶ 38a; statement of Canada before the United States Worldwide Unitary Taxation Working Group, Stip. ¶ 38c; submission of the Australian Government to the U.S. Task Force on Unitary Taxation, dated January 4, 1984, Stip. ¶ 38d; diplomatic note dated November 24, 1978, between George S. Vest, Assistant Secretary of State for European Affairs, and Francoise de Laboulaye, Ambassador of France, Stip. ¶ 48.

[8] Section 54 of and Schedule 13 to the Finance Act of 1985, reenacted as Sections 812-815 of the Income and Corporations Taxes Act, 1988.

use worldwide combined reporting.[9] Colgate would be directly affected by this legislation.

Similarly, on the domestic front, it has been the expressed policy of the federal government to oppose states' use of the worldwide combined reporting method of taxing multinational corporations because of that taxing method's impact upon relations with foreign nations. That opposition has been expressed in statements issued by the President, the Secretary of State and the Secretary of the Treasury.[10] The United States has appeared as amicus curiae to support the taxpayer in *Barclays* in all three California courts. Moreover, the federal government has issued statements, specific to this case, condemning worldwide combined reporting as applied to U.S.-based multinational taxpayers. For example, in a letter to Colgate, then-United States Secretary of the Treasury Nicholas Brady wrote on behalf of the Departments of Treasury, Justice and State and the U.S. Trade Representative that "we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations" (hereinafter "Secretary Brady's Letter").[11]

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[9] House of Commons Official Report, *Parliamentary Debates* (Hansard), 1036 (9 July 1985) (statement of John Moore).

[10] *See, e.g.*, Statement of the President of the United States, dated November 8, 1985, Stip. ¶ 31, App. F at 90a, 100a; letter from George Shultz, Secretary of State, to the Governor of California dated January 30, 1986, Stip. ¶ 33, App. F at 90a, 100a.; letter from James A. Baker III, Secretary of the Treasury, to Senator Bob Packwood, Chairman of the Senate Finance Committee, dated March 5, 1986, Stip. ¶ 32, App. F at 101a.

[11] *See* Letter from Nicholas Brady, Secretary of the Treasury, to Reuben Mark, Chairman and Chief Executive Officer of Colgate, dated September 13, 1991, attached to Colgate's Petition for Review to the California Supreme Court, dated September 30, 1991.

5. The Assessment

Colgate timely filed California franchise tax returns for the income years 1970 through 1973, reporting the income earned from its foreign operations on a separate accounting basis. The Franchise Tax Board determined that Colgate's tax should be determined on the basis of worldwide combined reporting. Colgate paid the additional tax owing under the Franchise Tax Board's method of computation and filed claims for refund which were denied.

6. The Proceedings Below

a. How the Federal Questions Were Raised and Passed On Below

In its complaint and briefs in the California Superior Court, in its briefs in the California Court of Appeal, and in its briefs in the California Supreme Court, Colgate contended that the Commerce Clause precluded California from using the worldwide combined method of taxation. Colgate also raised other constitutional objections below which it is not pressing before this Court. The California Superior Court and the California Court of Appeal explicitly noted and ruled on Colgate's Commerce Clause claims. App. F at 102a; App. B at 26a. The California Supreme Court, after remanding the case back to the Court of Appeal (App. C at 27a), subsequently denied Colgate's petition for review. App. A at 1a.

b. The Decisions Below

i. California Superior Court

The California Superior Court, after reviewing all the evidence of the federal government's policy towards worldwide combined reporting, found that it did indeed interfere with United States foreign policy. In reaching this conclusion, the trial court rejected the contentions of the Franchise Tax Board that Congress had expressly approved of California's method

of taxation, thereby rendering dormant Commerce Clause analysis unnecessary. On the contrary, the trial court found as a factual matter "that the executive branch of the federal government has clearly expressed a federal policy supporting the principle of water's edge taxation of multinational corporations and disapproving the world-wide unitary method ... and that the legislative branch has not expressed a contrary policy." App. F at 97a-98a.

Moreover, the trial court found that the policy of the United States was the same whether the worldwide unitary method of taxation was applied to U.S.-based multinational groups (such as Colgate) or to foreign-based multinational groups (such as the petitioner in *Barclays*). As noted by the trial court, "[t]he condemnation of the worldwide unitary method applies to all instrumentalities of foreign commerce, not just foreign based corporate groups." App. F at 90a.

In reaching its conclusion, the trial court found that this case differed dramatically in its factual posture from *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). In *Container*, this Court addressed the same issue, that is, the constitutionality of worldwide combined reporting, but found that it had no evidence of a clear statement by the federal government regarding the impact of worldwide combined reporting on federal foreign policy. *Container*, 463 U.S. at 195 n.33. Here, by contrast, the trial court found that the evidence which was lacking in *Container* had been supplied by the Executive Branch and introduced by Colgate. App. F at 90a. In light of this finding, the trial court held that California's method of taxation violated the Foreign Commerce Clause.

ii. Court of Appeal (First Opinion)

The Court of Appeal reversed. The court agreed with the trial court that Congress had not expressed a policy in favor of California's method of taxation, thus necessitating analysis under the dormant Commerce Clause. However, although it

had held in *Barclays* that worldwide combined reporting violated the Foreign Commerce Clause as applied to a foreign-based multinational group, the court stated that it would not invalidate the tax under the Foreign Commerce Clause without an explicit statement of federal hostility towards worldwide combined reporting in the context of a U.S.-based multinational group. The Court of Appeal justified its conclusion by noting repeatedly that the federal government had been notified about this case by counsel for Colgate and yet "the executive branch has done nothing here to make its position known" in this case. App. E at 57a.

iii. California Supreme Court

Colgate's petition for review to the California Supreme Court was based largely on statements by the federal Executive Branch condemning worldwide combined reporting as applied to Colgate, which were released after the Court of Appeal indicated that previous statements were insufficient. The California Supreme Court granted Colgate's petition for review. App. D at 28a. Before the case was set for argument, however, the court issued its decision in *Barclays*. In addressing the constitutionality of worldwide combined reporting as applied to a foreign-based multinational group, the court did not deal at all with the policy statements of the Executive Branch, and instead found that any inquiry into the validity of worldwide combined reporting under the Foreign Commerce Clause was precluded by Congress's consent to the state taxation at issue. The court found this consent, not in any affirmative congressional action, but rather in what the court referred to as "the din of a 'governmental silence.'" *Barclays*, 2 Cal. 4th at 732. Relying on *Wardair Canada, Inc. v. Florida Dep't of Rev.*, 477 U.S. 1 (1986), the court held that "recent foreign commerce clause jurisprudence reflects a diminution in the reach of the dormant foreign commerce clause analysis in favor of an expanded recognition that, under circumscribed conditions, governmental silence may constitute a ratification of state

taxation of foreign commerce, rendering a dormant analysis inapposite." *Id.* at 714.

Since the five factors that the court found sufficient to constitute congressional consent to states' use of worldwide combined reporting in *Barclays* were also present in this case, the court remanded this case to the Court of Appeal for it to reconsider its prior opinion in light of the California Supreme Court's decision in *Barclays*. App. C at 27a.

iv. Court of Appeal (Second Opinion)

On remand, the Court of Appeal recognized that "for purposes of whether *Wardair* applies in light of the factors cited by the [Franchise Tax] Board, there is no distinction between this case and *Barclays*." App. B at 18a. The court therefore found itself "obligated to adopt the analysis in *Barclays* regarding *Wardair*'s applicability" (App. B at 18a) and held that Congress had consented to the states' application of worldwide combined reporting to domestic-based groups.

v. California Supreme Court

On February 18, 1993, the California Supreme Court denied Colgate's petition for review of the revised opinion of the Court of Appeal. App. A at 1a.

REASONS FOR GRANTING THE WRIT

The decision of the California Court of Appeal warrants review by this Court for three compelling reasons. First, as noted above, the issues in this case are intimately related to those raised by the petition for certiorari filed in *Barclays*. If the petition for certiorari is granted in *Barclays*, proper consideration of the issues raised by that petition, including the ramifications for U.S.-based multinational groups raised in this petition, requires that this petition likewise be granted. Second, the Court of Appeal's resolution of the congressional consent and Foreign Commerce Clause issues raised by this case is in-

compatible with prior decisions of this Court and, if left undisturbed, would upset the constitutional balance between state and federal authority that the Framers created. Third, the questions raised by this case have profound national and international significance that merits plenary consideration in its own right.

I. IF THE PETITION FOR CERTIORARI IN *BARCLAYS* IS GRANTED, PROPER CONSIDERATION OF THE QUESTIONS THERE PRESENTED COMPELS THAT COLGATE'S PETITION LIKEWISE BE GRANTED

Proper consideration of the questions presented in *Barclays* compels that Colgate's petition be granted. The issues raised by the petition in *Barclays* — issues concerning the constitutionality of worldwide combined reporting under the Commerce Clause and the criteria for determining whether Congress has consented to state action under the Commerce Clause — are the issues that lie at the heart of Colgate's petition. If the *Barclays* petition is certworthy, and Colgate is confident that the Court will determine that it is, then it follows that Colgate's petition should likewise be granted so that the ultimate disposition of the issues shared by the two cases will be the same.

Both the petition in *Barclays* and this petition raise *exactly* the same issue regarding whether Congress has consented to California's use of worldwide combined reporting. The congressional silence which was viewed by the court below as consent to California's method of worldwide combined reporting is an equally complete silence for both U.S.-based and foreign-based multinational groups. The instances of failure to act relied upon by the California courts to imply consent are identical in this case and *Barclays*. *See, e.g.*, App. B at 16a; *Barclays*, 2 Cal. 4th at 733-41.

There is, to be sure, a difference between the two cases: *Barclays* involves a foreign-based multinational group, while this case involves a U.S.-based multinational group. This difference, however, merely reinforces the considerations that militate in favor of granting Colgate's petition in this case. Simply stated, the Commerce Clause requires that the foreign commerce conducted by a U.S.-based multinational group be taxed in the same way as the foreign commerce conducted by a foreign-based multinational group. Thus, under the Commerce Clause, if California cannot apply worldwide combined reporting to the taxpayer in *Barclays*, California cannot use worldwide combined reporting to tax Colgate.

This Court has held that it is unconstitutional under the Commerce Clause to prefer one form of "protected" commerce over another. This issue was expressly addressed in *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977), in which the Court struck down a tax statute which discriminated between two types of transactions, both of which were in interstate commerce. The Court expressly rejected the apparent view of the New York Court of Appeals that discrimination between two kinds of transactions in interstate commerce was permissible. *Id.* at 333. In particular, the Court disapproved discrimination between different forms of protected commerce where such discrimination would result in a "diminution of free competition," which the Court viewed as "wholly inconsistent with the free trade purpose of the Commerce Clause." *Id.* at 336. If California is permitted to apply worldwide combined reporting to U.S.-based multinational groups such as Colgate and its affiliates, but not to foreign-based multinational groups such as the one involved in *Barclays*, the resulting competitive advantage to foreign-based multinational groups would seriously undermine the level playing field for different forms of protected commerce which is the essence of the free trade purpose of the Commerce Clause.

The necessity for equal treatment of all forms of protected commerce was reemphasized last term when the Court struck down a state tax scheme which favored interstate over foreign commerce. *Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev. and Finance*, 112 S. Ct. 2365 (1992). In addition, in *Zee Toys, Inc. v. County of Los Angeles*, 85 Cal. App. 3d 763, 149 Cal. Rptr. 750 (2d Dist. 1978), *aff'd by an equally divided court sub nom. Sears, Roebuck & Co. v. County of Los Angeles*, 449 U.S. 1119 (1981), the California Court of Appeal, in a decision that was affirmed by this Court, explained:

> Discrimination between (1) interstate transactions and foreign transactions cannot be distinguished from (2) discrimination between two types of interstate transactions. Both interstate and foreign transactions are brought within the control of Congress by the same clause of the United States Constitution.

Zee Toys, 85 Cal. App. 3d at 775. The Constitution will therefore not permit discriminatory taxation of foreign commerce conducted through U.S.-based groups in favor of foreign commerce conducted through foreign-based groups.

Although the Court found it unnecessary to reach this issue in *Container*, several members of the Court made it clear that invalidating worldwide combined reporting as applied only to foreign-based multinationals would be "unacceptable" because "[i]t would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation." *Container*, 463 U.S. at 203 (Powell, J., dissenting).

In short, if California's worldwide combined reporting tax scheme as applied to foreign-based multinational groups violates the Commerce Clause, then application of the tax scheme to domestic-based multinational groups such as Colgate cannot withstand constitutional scrutiny. In light of this fact, the proper disposition of *Barclays* and that of the instant case are inextricably intertwined. If this Court grants the petition in *Barclays*, it should grant the petition in this case in order to avoid the creation of a constitutionally unacceptable scheme

whereby worldwide combined reporting is declared unconstitutional as regards foreign-based multinational groups, but remains constitutional as applied to domestic-based groups.

II. THE DECISION BELOW IS INCOMPATIBLE WITH PRIOR DECISIONS OF THIS COURT AND, IF LEFT UNDISTURBED, WILL UNDERMINE THE FUNDAMENTAL VALUES OF FREE TRADE THAT THE COMMERCE CLAUSE WAS DESIGNED TO PROTECT

The decision below rests squarely on the California Supreme Court's determination in *Barclays* that Congress has consented to the states' use of worldwide combined reporting, thereby precluding any inquiry into its defensibility under the dormant Commerce Clause. However, the Court of Appeal's holding, which flows directly from the California Supreme Court's opinion that congressional consent to state action may be gleaned from congressional silence, has created an irreconcilable conflict with prior decisions of this Court.

It is well-established that when Congress exercises its power under the Commerce Clause to consent to a state law, any question of the validity of that state law under the dormant Commerce Clause disappears, even though that state law might otherwise burden interstate or foreign commerce. As this Court recognized in *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408 (1946), because Congress has plenary power over the channels of interstate commerce, "Congress may keep the way open, confine it broadly or closely, or close it entirely," *id.* at 434, subject only to the limitations that the Constitution imposes on Congress's own power. This includes, of course, the power to authorize state laws that discriminate against or otherwise burden interstate commerce, laws that would be struck down in the absence of congressional action consenting to them. *Id.*

Recognizing the considerable consequences that emanate from a finding of congressional consent, this Court has consistently required that Congress manifest its consent to state law through unambiguous affirmative action. Thus the Court has repeatedly stressed that "[a]n unambiguous indication of congressional intent is required before a federal statute will be read to authorize otherwise invalid state legislation" and provide an "exemption from Commerce Clause scrutiny." *Maine v. Taylor*, 477 U.S. 131, 138-39 (1986); *see also Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992) ("Congress must manifest its unambiguous intent before a federal statute will be read to permit or to approve ... a violation of the Commerce Clause ..."); *South-Central Timber Dev. Inc. v. Wunnicke*, 467 U.S. 82, 91-92 (1984) (rejecting "'implicit approval' theory" of congressional consent and reaffirming "[a] rule requiring a clear expression of approval by Congress"); *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 960 (1982) ("In the instances in which we have found such [congressional] consent, Congress' '"intent and policy" to sustain state legislation from attack under the Commerce Clause' was '"expressly stated."'"); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 343 (1982) ("[W]hen Congress has not 'expressly stated its intent and policy' to sustain state legislation from attack under the Commerce Clause, ... we have no authority to rewrite its legislation based on mere speculation as to what Congress 'probably had in mind.'").

Despite this well-established body of case law, the California Court of Appeal found itself "obligated" to adopt the California Supreme Court's decision in *Barclays* that Congress has consented to California's use of worldwide combined reporting. Moreover, the California Supreme Court found this consent not in unambiguous affirmative action, but rather in "the din of a 'governmental silence.'" *Barclays*, 2 Cal. 4th at 732. The court justified its novel approach by relying almost exclusively on this Court's decision in *Wardair*, finding that case to represent "if not a change of course in the high

court's dormant commerce clause jurisprudence, at least a retrenchment in its scope." *Barclays*, 2 Cal. 4th at 731. The California Supreme Court's conclusion that congressional silence and inaction can form the basis of congressional consent, however, cannot be reconciled with *Wardair*, or with decisions of this Court prior to and following *Wardair*. Indeed, *Wardair* itself found consent on the basis that "the Federal Government has not remained silent" but rather "has affirmatively decided to permit" the state taxation at issue. *Wardair*, 477 U.S. at 12.

Moreover, the inaction of Congress in this case is inconsistent with any plausible view of consent and certainly does not establish the factual basis for consent found in *Wardair*. Whereas the Court in *Wardair* found consent in a series of international agreements that specifically considered the state taxation at issue, the California Supreme Court and, by following it, the court below found consent by implication in a series of congressional inactions and failures to act. In *Wardair*, the Court relied on an international agreement that expressly prohibited state taxation of certain fuel and thereby reflected Congress's consent to the imposition of other state taxes on aviation fuel, including the tax at issue. The Court also considered a second resolution that addressed the question of state taxation of aviation fuel. On the basis of these foundational documents, which specifically considered the question of subnational taxation, the Court found that subsequent agreements, which precluded only national taxes on aviation fuels, revealed a conscious decision to permit the state taxes at issue.

This affirmative action may be contrasted with the five items of inaction which the California Supreme Court and the court below identified as signifying congressional consent to the use of worldwide combined reporting. Four of the items relied upon do not even mention the question of states' use of worldwide combined reporting, expressing no more than a preference for separate accounting at the federal level. The single item which even addresses the question of states' use of

worldwide combined reporting is the failure to obtain the two-thirds vote necessary to ratify a treaty containing a provision prohibiting states' use of worldwide combined reporting. However, the treaty with the provision included received a favorable vote of 49 to 32, falling only five votes short of the required two-thirds vote necessary for the ratification of the treaty. A majority of Senators therefore voted to *support* the provision, negating any possible inference of consent from the failure to act.[12] Moreover, petitioner submits that a *senatorial* failure to ratify a treaty cannot be held up as an indicator of *congressional* consent for states' use of worldwide combined reporting.

Finally, the five factors found to constitute congressional consent by the California Supreme Court and the court below all existed prior to this Court's decision in *Container*. Nevertheless, despite the presence of these factors at that time, this Court engaged in dormant Commerce Clause analysis and implicitly concluded that Congress had not consented to worldwide combined reporting.

The Court of Appeal's attack on this Court's criteria for determining congressional consent warrants review. First, important policies of free trade protection surround this Court's insistence on clear expressions of congressional consent, and these policies will be jeopardized if review is not granted. The Court has protected the core value of free trade within a national market in its numerous decisions under the dormant Commerce Clause, striking down state laws that burden interstate commerce. But to expose interstate or foreign commerce to burdensome state legislation without the clearest signal from Congress of its intent to strip such commerce of the protections it ordinarily enjoys would undermine our constitu-

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[12] Indeed, the failure to ratify the treaty with the provision included reflects more the concern of the Senate that the treaty ratification process was not the appropriate forum to consider such a curb on states' powers. *See* Remarks of Senator Matsunga, 124 Cong. Rec. 18,669 (1978).

tional scheme. "Absent 'a clear expression of approval by Congress,' any relaxation in the restrictions on state power otherwise imposed by the Commerce Clause unacceptably increases 'the risk that unrepresented interests will be adversely affected by restraints on commerce.'" *Maine v. Taylor*, 477 U.S. at 139.

Second, there is no justification either in constitutional policy or in this Court's precedents for the extraordinary suggestion of the court below that congressional silence constitutes consent under the Commerce Clause. As we have explained above, both policy and law are to the contrary, and the California court has advanced no sound reason for abandoning them. In any event, it is clearly the prerogative of this Court — not a state court — to determine whether the Court's decisions should be overturned. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989).

Third, even if there are some suggestions in *Wardair* that the "negative implications," 477 U.S. at 10, of affirmative congressional action can lay the evidentiary predicate for a finding of congressional consent to state law, these suggestions do not license a state court to base a finding of consent on the negative implications of congressional *inaction*, which is what the California court did here. The Court in *Wardair* explicitly declared that it was drawing negative inferences from governmental action — not governmental omission — in finding that Congress had affirmatively consented to the tax at issue. The suggestion that *Wardair* "represents, if not a change of course in the high court's dormant foreign commerce clause jurisprudence, at least a retrenchment in its scope," *Barclays*, 2 Cal. 4th at 731, is unfounded. *Wardair* is woven from the same thread as the Court's earlier decisions involving congressional consent, as well as from its later decisions. Indeed, the claim that there has been a "retrenchment" in the Court's Foreign Commerce Clause jurisprudence is belied by the Court's most recent decisions in this domain. *See Itel Containers Int'l Corp. v.*

Huddleston, 113 S. Ct. 1095 (1993);[13] *Kraft*, 112 S. Ct. 2365 (1992). In any event, insofar as one might read *Wardair* as relaxing the standards for finding congressional consent to state law, *Wardair*, 477 U.S. at 18-20 (Blackmun, J., dissenting), it is incumbent upon this Court to clarify those standards so they will not be subject to the misreading that they received below.

Finally, the implications of the decision below are so destructive of the free trade purposes underlying the Commerce Clause, which provides the basis for this Court's dormant Commerce Clause jurisprudence, that it should not be left undisturbed. Under the California court's analysis, "silence" becomes a basis for inferring consent to state law under the Commerce Clause. Yet it is this very "silence" that has for two centuries been the basis for the Court's dormant Commerce Clause jurisprudence. If congressional silence can justify a finding of congressional consent to state laws, then there may well be no room for the dormant Commerce Clause to operate at all. At a minimum, its scope may be substantially narrowed, and courts will have to distinguish between the kinds of "silence" that warrant a dormant Commerce Clause inquiry and those that preclude judicial scrutiny of state law altogether. These questions are indisputably worthy of this Court's attention.

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[13] In *Itel*, this Court considered whether a sales tax on containers violated the Foreign Commerce Clause despite the existence of two international Container Conventions to which the U.S. was a signatory, and federal regulations. Both the Conventions and the federal regulations restricted taxation on international containers. Far from reasoning that Congress, by prescribing certain taxes on containers, had implicitly consented to state taxation on those containers, this Court readily engaged in dormant Commerce Clause analysis.

III. THE DECISION BELOW PRESENTS AN ISSUE OF PROFOUND NATIONAL AND INTERNATIONAL SIGNIFICANCE THAT MERITS PLENARY CONSIDERATION IN ITS OWN RIGHT

Wholly apart from the conflict that the decision below has created with decisions of this Court, the decision warrants this Court's review in its own right. The precise scope of the constitutional restraints on the states' power to impose a tax that conflicts with the clear, expressed policy of the federal government is a question of profound significance for our relations with foreign nations that calls for this Court's attention and guidance. This Court has recognized that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce." *Kraft*, 112 S. Ct. at 2370 (citing *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 445-46(1979)). Foreign commerce merits broader protection because "matters of concern to the entire Nation are implicated," *Kraft*, 112 S. Ct. at 2370 (quoting *Japan Line*, 441 U.S. at 448), including "sensitive matters of foreign relations and national sovereignty." *Japan Line*, 441 U.S. at 456. Nowhere are those sensitive matters of foreign relations more at issue than in this case.

In a series of decisions handed down during the late 1970s and early 1980s, this Court delineated the Commerce Clause limitations on the states' power to tax foreign commerce. Thus, these decisions established that a state tax cannot survive scrutiny under the Foreign Commerce Clause if the tax would "impair federal uniformity in an area where federal uniformity is essential," *Japan Line*, 441 U.S. at 448, or prevent "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Id.* at 451 (quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976)). In *Container*, this Court established that a state tax will violate the "one voice" standard of the Foreign Commerce Clause if that tax either implicates foreign policy issues that

must be left to the federal government or violates a *clear federal directive*. *Container*, 463 U.S. at 194. Thus, the question before this Court is whether a statement from the federal government opposing California's method of taxing multinational corporations, made in the context of federal foreign policy concerns, evidences a violation of the "one voice" standard.

The question whether California's inclusion of foreign operations in a single unitary business with United States operations violates the Commerce Clause through its interference with federal foreign policy came before the United States Supreme Court in *Container*. However, at the time that this Court decided *Container*, the Court found that it did not have before it a clear statement by the Executive Branch regarding the impact of California's method of taxation on federal foreign policy. This Court explained the reason for its conclusion that it could not determine the position of the Executive Branch as follows:

> The Solicitor General did submit a memorandum opposing worldwide formula apportionment by a State in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349, a case that was argued last Term, and carried over to this Term. Although there is no need for us to speculate as to the reasons for the Solicitor General's decision not to submit a similar memorandum or brief in this case ... there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case.

Container, 463 U.S. at 195 n.33. The Court thus indicated its reluctance to find that California's method of taxation impermissibly interferes with federal foreign policy, in the absence of a clear statement of the position of the federal government.

More recently, the Court distinguished the worldwide combined reporting method of taxation which it upheld in *Container* from the ad valorem tax which it struck down in *Japan Line*, on the basis that "'in [*Container Corp.*], unlike *Japan Line*, the Executive Branch ha[d] decided not to file an *amicus curiae* brief in opposition to the state tax.'" *Itel*, 113 S. Ct. at

1103 (quoting *Container*, 463 U.S. at 195). The Court therefore concluded that "the Government's nonintervention suggested that the tax presented no serious threat to United States foreign policy." *Id.* at 1104.

The missing evidence which was crucial in *Container* has now been supplied by the federal government. In response to a specific request from Colgate that the federal government state its position on worldwide combined reporting and make that position explicit beyond doubt in the context of domestic-based multinational groups, the federal government issued the following response:

> As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations.

Secretary Brady's Letter.[14]

Moreover, this statement does not represent a new policy of the federal government. In fact, this statement does no more than elaborate on the plain language of prior Executive Branch statements which clearly condemn the application of worldwide combined reporting to all multinational groups. On November 8, 1985, the President issued a statement instructing the Secretary of the Treasury to pursue through legislation, and the Attorney General to pursue in appropriate cases in litigation, the federal policy that multinationals be taxed by states only on income derived from the territory of the United States. *See* App. F at 90a. Similarly, on January 30, 1986, Secretary of State George Shultz wrote to the Governor of California that "employment of worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states." *See*

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[14] This Court has frequently recognized Executive Branch letters as valid evidence of the policy of the federal government. *See, e.g., Zschernig v. Miller*, 389 U.S. 429 (1968).

App. F at 91a. Since that time, the federal government has pursued its opposition to worldwide combined reporting through many efforts, including appearing as *amicus curiae* for the taxpayer in *Barclays* in each of the California courts.

In *Itel*, in holding that the Tennessee sales tax at issue did not violate the Foreign Commerce Clause, this Court found the view of the United States government determinative. Indeed, citing *Wardair*, this Court stated that it would be turning dormant Commerce Clause "'upside down ... to apply it in a way as to *reverse* the policy that the Federal Government has elected to follow.'" *Itel*, 113 S. Ct. at 1105 (citing *Wardair*, 477 U.S. at 12). Similarly, if this Court allows the lower decision to stand, the policy of the federal government will have effectively been reversed, with the resulting instability both nationally and internationally that will follow from that reversal.

Quite simply, therefore, *Container* held that, in the absence of a clear statement of the position of the Executive Branch, the Court would not on its own invalidate California's tax. *Container* did not decide the limits on a state's power to tax multinational corporations in the face of direct federal government opposition to that taxing method. These are the questions we are asking this Court to review.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,
James P. Kleier
Counsel of Record
Walter Hellerstein
Prentiss Willson, Jr.
Clare M. Rathbone
Morrison & Foerster
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

APPENDIX A

COLGATE-PALMOLIVE COMPANY,
Respondent,

v.

FRANCHISE TAX BOARD,
Appellant.

No. S023147.

Supreme Court of the State of California,
in Bank.

Feb. 18, 1993.

Respondent's petition for review DENIED.

LUCAS
Chief Justice

Filed February 18, 1993

Robert Wandruff, Clerk
Deputy

APPENDIX B

COLGATE-PALMOLIVE COMPANY,
Plaintiff and Respondent,

V.

FRANCHISE TAX BOARD,
Defendant and Appellant.

No. C007044.

Court of Appeal of the State of California,
Third Appellate District.

Nov. 20, 1992

DAVIS, J.

The principal issue in this appeal is whether California's worldwide unitary method of taxation (based on Rev. & Tax. Code, §§ 25101, 25120-25139), as applied to domestic-parent unitary corporate groups, is unconstitutional under the foreign commerce clause of the United States Constitution. (U.S. Const., art. I, § 8, cl. 3.)[1] Using the dormant foreign commerce

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[1] During the tax years at issue (1970-1973), Revenue and Taxation Code section 25101 provided in pertinent part: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter);..."

California's version of the Uniform Division of Income for Tax Purposes Act (UDITPA), is contained in Article 2. That Act provides for formula apportionment of the net income from business activities both within and

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clause analytical framework set forth in *Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434 [60 L.Ed.2d 336, 99 S.Ct. 1813] and *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159 [77 L.Ed.2d 545, 103 S.Ct. 2933], we originally concluded that the tax method does not violate that clause. Several months after we issued our decision, the California Supreme Court issued its decision in *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.* (1992) 2 Cal.4th 708 [8 Cal.Rptr.2d 31, 829 P.2d 279] (*Barclays*). On June 18, 1992, the Supreme Court directed us to vacate our original decision in this case and refile it after modification in light of *Barclays*. The parties then filed supplemental briefs. As we explain, *Barclays* effects a substantial change in our foreign commerce clause analysis but no change in our original result. Consequently, we still reverse that part of the judgment regarding the foreign commerce clause issue and affirm that part of the judgment regarding the statutory and constitutional distortion issues.

BACKGROUND

The Methods of Allocating Income

When a corporation, either on its own or through subsidiaries, conducts business across state or national boundaries, the allocation of income to each relevant jurisdiction for purposes of taxation becomes an issue. To resolve this issue, two general methods of income allocation have been created: the arm's length/separate accounting method and the unitary business/formula apportionment method. Each of these two general methods can be applied in varying ways. (*Container Corp. v. Franchise Tax Bd., supra*, 463 U.S. at pp. 182, 191, 196 [77

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outside California in order to reach the net income attributable to California activities. (Rev. & Tax. Code, §§ 25120-25139.)

In 1982, section 25101 was amended in a manner insignificant to our purposes. (States. 1982, ch. 466, § 104, p. 2055.)

L.Ed.2d at pp. 564, 570, 573]; Langbein (1986) 23 Tax Notes 625, 626; Note, *State Worldwide Unitary Taxation: The Foreign Parent Case* (1985) 23 Colum. J. of Transnat'l L. 445, 451, hereafter 23 Columbia Journal.)

Under separate accounting, the related corporations of a multijurisdictional enterprise are viewed as distinct from one another; taxable income is determined separately for each individual corporation by the jurisdiction in which that corporation actually conducts business or has a permanent establishment. Any improper shifting of value between the related corporations to avoid taxes is corrected by requiring "arm's length" pricing in related corporate transactions. In other words, the related corporations must act as if they were unrelated entities dealing at arm's length in the marketplace.

In contrast, under the unitary business/formula apportionment method of allocating income at issue in this case — the worldwide unitary method — the related corporations of a multijurisdictional enterprise are treated as units of a single business — that is, as a "unitary group." (Cal. Code Regs., tit. 18, § 25137-6.)[2] If a corporation doing business in California is deemed to be part of a unitary group, the total income for that group worldwide, including corporations operating wholly outside the United States, is apportioned to California by a three-factor formula. Under the formula, the property, payroll, and sales figures for the group in California are arithmetically compared to the property, payroll, and sales figures for the group worldwide. (See Rev. & Tax. Code, §§ 25128-25136.) This comparison results in a proportion that is multiplied against the unitary group's worldwide income, producing an

[2] Generally, a corporation is included within the unitary group if its activities outside California are dependent upon or contribute to the business of a related corporation within California. (See *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472 [183 P.2d 16].)

apportioned amount of such income taxable by California.[3] Simply put, if 25 percent of the property, payroll, and sales of the unitary group is located in California, then 25 percent of the group's worldwide income is apportioned to California. Under this method, it is unnecessary to make "arm's length" corrections because intercorporate transactions are disregarded.

Aside from a few minor exceptions, the income allocation method used by the United States and all of the other nations of the world is the separate accounting, method, although, as noted, this method varies in practice. However, the United States has basically limited the application of its tax treaties to federal taxes. (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at p. 196 [77 L.Ed.2d at p. 573].)[4]

[3] The amount of the unitary group's income taxable by California is calculated as follows:

$$\frac{\frac{\text{In-State Property}}{\text{Total Property}} + \frac{\text{In-State Payroll}}{\text{Total Payroll}} + \frac{\text{In-State Sales}}{\text{Total Sales}}}{3} \times \begin{array}{l}\text{Unitary}\\ \text{Group's Total}\\ \text{Worldwide}\\ \text{Income}\end{array} = \text{Income Taxable by California.}$$

(Rev. & Tax. Code, §§ 25128-25137; 23 Columbia Journal at p. 445, fn. 2.)

[4] California in 1986 passed legislation, effective January 1, 1988, permitting taxpayers to make a "water's-edge election" notwithstanding Revenue and Taxation Code section 25101 (Rev. & Tax. Code, § 25110 et seq.).

This "water's-edge" method restricts tax allocation methods to the United States as the jurisdictional boundary, and offers an alternative to the worldwide unitary method for determining taxable income. (See Rev. & Tax. Code, §§ 25101, 25110.) Rather than accounting for the income and apportionment factors (property, payroll, and sales) of all the corporations of its worldwide unitary group, a corporate taxpayer making such an election accounts for the income and apportionment factors of the following entities affiliated with it, subject to some minor exceptions: corporations incorporated in the United States; any corporation, wherever incorporated, if the average of its apportionment factors within the United States is 20

Footnote continued...

The present controversy involves Colgate-Palmolive Company, Inc. (Colgate), a domestic-parent unitary corporate group with approximately 75 foreign subsidiaries operating in

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percent or more; affiliated corporations which are eligible to be included in a federal consolidated tax return; domestic international sales corporations and foreign sales corporations engaged in sales in the United States; export trade corporations; any corporation not mentioned above but only to the extent of income derived from or attributable to sources within the United States; and any affiliated corporation which is a controlled foreign corporation as defined in the Internal Revenue Code. Any corporation not subjected to the worldwide unitary method under Revenue and Taxation Code section 25101 need not be included in this "water's-edge" accounting. (Rev. & Tax. Code, § 25110, subd. (a).)

In general, this election permits a taxpayer corporation to exclude the income and apportionment factors of foreign subsidiaries from the corporation's California tax base. An accounting restriction to the water's edge of the United States in the present context would mean that California could rely only on income derived from permanent establishments of Colgate in the United States, and not on income derived from wholly foreign interests, to calculate Colgate's franchise tax.

To qualify for the "water's-edge" election, the corporate taxpayer must (1) consent to the taking of depositions from key corporate personnel and to the production of documents to ensure the Franchise Tax Board has the information necessary to make genuine arm's length adjustments and unitary business investigations, and (2) agree that dividends received by any affiliated entity from corporations significantly related to the unitary business constitute business income of the taxpayer. (Rev. & Tax. Code, § 25110, subd. (b)(2).) Additionally, to qualify the corporate taxpayer must enter into a five-year contract with the Franchise Tax Board, pay an annual fee, and subject itself to various conditions. (Rev. & Tax. Code, §§ 25111-25115.)

A domestic-parent multinational corporation that does not make this election is subjected essentially to the 1970-1973 taxation method at issue here. (See fn. 1, *ante*.) We emphasize, however, that the principal issue in this case is the foreign commerce clause constitutionality of California's worldwide unitary tax method as applied to domestic-parent unitary corporate groups with foreign subsidiaries (Rev. & Tax. Code, §§ 25101 et seq.). Because California's "water's-edge election" is not involved in this case, we do not express any views regarding it. (Rev. & Tax. Code, § 25110 et seq.)

about 54 foreign counties [sic].[5] Colgate was directed to pay additional taxes for the years 1970 through 1973 after California applied the worldwide unitary tax method to the group. Under protest, Colgate paid the additional takes and this suit ensued.

The Issues on Appeal

At trial, Colgate challenged the federal constitutionality of these additional taxes on foreign commerce clause grounds. The thrust of Colgate's argument below was that the federal executive branch acted decisively after the *Container* decision to communicate its longstanding position that California's worldwide unitary tax method impermissibly interferes with American foreign policy; according to Colgate, this decisive action eliminated the factual ambiguity that resulted in the *Container* decision. The trial court agreed with this argument and determined that California's worldwide unitary tax method was unconstitutional on this ground. The Franchise Tax Board (the Board) appeals that decision here.

Colgate also argued at trial that California's three-factor unitary formula unlawfully "distorted" the amount of Colgate's income apportioned to California. The trial court found against Colgate on this issue, which Colgate again raises in its respondent's brief.[6]

Finally, two peripheral issues are raised by the Board in this appeal. First, the Board claims the trial court abused its discretion in denying the Board's motion for discovery sanctions. Secondly, the Board asserts the court below erroneously awarded certain costs to Colgate.

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[5] Reversing its position below, Colgate on appeal does not dispute that it is a domestic-parent unitary corporate group.

[6] The Board moved to strike this argument on appeal, contending it was improperly raised in these proceedings. We denied the Board's motion.

The Foreign Commerce Clause

Article I, section 8, clause 3 of the United States Constitution empowers Congress "To regulate commerce with foreign nations, and among the several states, and with the Indian tribes." As the United States Supreme Court has long emphasized, this clause limits the power of the States even in the absence of Congressional legislation. (*Boston Stock Exchange v. State Tax Comm'n.* (1977) 429 U.S. 318, 328 [50 L.Ed.2d 514, 523, 97 S.Ct. 599]; *Freeman v. Hewit* (1946) 329 U.S. 249, 252 [91 L.Ed.2d 265, 271, 67 S.Ct. 274].) In this respect, the commerce clause indirectly allocates the relative powers of states and the federal government. (*Star-Kist Foods, Inc. v. County of Los Angeles* (1986) 42 Cal.3d 1, 9 [227 Cal.Rptr. 391, 719 P.2d 987].)

As noted in *Star-Kist*, "[d]etermining whether a state tax exceeds the bounds of permissible state action under the [commerce] clause is often a difficult task." (42 Cal.3d at p. 10.) In the context of the foreign commerce clause, there are three United States Supreme Court decisions that have delineated the test under which this determination is made: *Japan Line, Ltd. V. County of Los Angeles, supra*, 441 U.S. 434; *Container Corp. v. Franchise Tax Bd., supra*, 463 U.S. 159; and *Wardair Canada v. Florida Dept. of Revenue* (1986) 477 U.S. 1 [91 L.Ed.2d 1, 106 S.Ct. 2369].

Applying the foreign commerce clause test it created, the court in *Japan Line* held that instrumentalities of commerce — in that case, seagoing cargo containers — which are foreign-owned, -based, and -registered and which are used solely in international commerce may not be subjected to a state's apportioned ad valorem property tax. (441 U.S. at pp. 436, 444 [60 L.Ed.2d at pp. 340, 345].)

In creating the foreign commerce clause test, the *Japan Line* court noted that the issue of taxation between nations is more complicated than the issue of taxation between American states. This increased complexity results from a number of

factors, including the greater sensitivity to national as opposed to state sovereignty, the lack of an authoritative tribunal capable of resolving transnational disputes, and the fact that actions by individual states can work to the detriment of thSe whole country. (441 U.S. at pp. 447-451, 456 [60 L.Ed.2d at pp. 347-350. 352].) In light of these circumstances, said *Japan Line*, the foreign commerce power of Congress is greater than its interstate commerce power and the need for one national voice in regulating commercial relations with foreign nations is paramount. (*Id.* at pp. 448-449 [60 L.Ed.2d at pp. 347-348].)

From this comparison of the interstate and the foreign contexts, the foreign commerce clause test was born. That test was engendered by adding two inquiries onto the already existing four-part test for interstate commerce clause review. (*Japan Line, supra*, 441 U.S. at pp. 444-445, 451 [60 L.Ed.2d at pp. 345-346, 349-350].)

Under the four-part interstate test, a state tax will survive an interstate commerce clause challenge if the tax "'[i] is applied to an activity with a substantial nexus with the taxing State, [ii] is fairly apportioned, [iii] does not discriminate against interstate commerce, and [iv] is fairly related to the services provided by the State.'" (*Japan Line, supra*, 441 U.S. at pp. 444-445, 449, 454 [60 L.Ed.2d at pp. 345, 348, 352], quoting *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, 279 [51 L.Ed.2d 326, 331, 97 S.Ct. 1076].)

The two additional inquiries prompted by the foreign context are: first, whether the tax creates a "substantial risk of international multiple taxation" (441 U.S. at p. 451 [60 L.Ed.2d at p. 349]); and, second, whether the tax "may impair federal uniformity in an area where federal uniformity is essential" (*Id.* at p. 448 [60 L.Ed.2d 347]), and prevents "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" (*Id.* at p. 451 [60 L.Ed.2d at p. 349], quoting *Michelin Tire Corp. v. Wages*

(1976) 423 U.S. 276, 285 [46 L.Ed.2d 495, 96 S.Ct. 535]; see also *Container, supra*, 463 U.S. at pp. 193-194 [77 L.Ed.2d at pp. 571-572]). If a state tax violates either of these precepts, it is unconstitutional under the foreign commerce clause. (441 U.S. at p. 451 [60 L.Ed.2d at p. 349].)

Because the foreign commerce clause is self-executing, the judiciary applies this test when Congress or the federal government has not acted or purported to act. (*Merrion v. Jicarilla Apache Tribe* (1982) 455 U.S. 130, 154-155 [71 L.Ed.2d 21, 40-41, 102 S.Ct. 894]; *Wardair, supra*, 477 U.S. at pp. 7-8, 18 [91 L.Ed.2d at pp. 9-10, 16].) In such "dormant" foreign commerce clause situations, the judiciary must determine whether a particular state action unduly threatens the purpose of the clause: to ensure a unified national voice in foreign commerce matters raising inherently national concerns and to ensure that individual states do not work to the detriment of the whole nation. (*Ibid*; see also *Japan Line, supra*, 441 U.S. at pp. 448-449 [60 L.Ed.2d at pp. 347-348].)

In *Japan Line*, the state tax at issue was found to violate both of the additional foreign commerce clause considerations. Multiple taxation resulted because the foreign country involved, Japan, taxed the cargo containers at full value. (441 U.S. at pp. 451-452 [60 L.Ed.2d at pp. 349-350].) The "one-voice" standard was violated because the United States and Japan had signed a convention reflecting a national policy to preclude such taxes. Furthermore, American-owned cargo containers were not taxed in Japan; this created an asymmetry in international taxation disadvantageous to Japan and, under such circumstances, the risk of Japanese retaliation against the whole nation was substantial. Finally, if other states enacted their own taxing schemes, taxation would vary port-by-port, making speaking with one voice impossible. (*Id.* at pp. 452-453 [60 L.Ed.2d at pp. 350-351].)

That brings us to the decision in *Container Corp. v. Franchise Tax Bd., supra*, 463 U.S. 159. *Container* involved the precise issue presented here: the constitutionality under the foreign commerce clause of California's worldwide unitary tax method as applied to a domestic-parent unitary corporate group (hereafter, domestic-parent group) with foreign subsidiaries. (*Id.* at pp. 163, 171 [77 L.Ed.2d at pp. 551-552, 557].) Applying essentially the dormant foreign commerce clause test set forth in *Japan Line*, the court in *Container* held the tax method constitutional. (*Id.* at pp. 185-197 [77 L.Ed.2d at pp. 566-574].)

In applying *Japan Line's* first additional foreign commerce clause consideration — the enhanced risk of international multiple taxation — *Container* noted that separate accounting did not inevitably end double taxation and California's worldwide unitary method did not inevitably lead to it. Given this state of affairs, said *Container*, it would be perverse constitutionally to require one method of taxation over another when both could result in a double tax. (463 U.S. at pp. 189-193 [77 L.Ed.2d at pp. 568-571].)

Container refined *Japan Line's* second additional foreign commerce clause consideration — the "one voice" standard — by stating: "In conducting this inquiry, ... we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some explicit directive from Congress, ... that treatment of foreign income at the federal level mandates identical treatment by the States.' [Citations.] Thus, a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive. The second of these considerations is, of course, essentially a species of pre-emption analysis." (463 U.S. at p. 194 [77 L.Ed.2d at pp. 571-752], italics in original.)

According to *Container*, the most obvious foreign policy implication of a state tax is the threat it might pose of offending foreign trading partners, leading them to retaliate against the whole nation. The court in *Container* noted that the judiciary has little competence in making this determination and emphasized that the nuances of foreign policy "are much more the province of the Executive Branch and Congress than of this Court." (463 U.S. at pp. 194, 196 [77 L.Ed.2d at pp. 571-573].) The best a court can do, said *Container*, is try to develop objective standards reflecting general observations about international trade and relations. (*Id.* at p. 194 [77 L.Ed.2d at pp. 571-572].)

Doing just that, the court in *Container* set forth three reasons that weighed strongly against the possibility of justifiable and significant foreign retaliation. First, California's worldwide unitary tax method as applied to domestic-parent groups did not create an *"automatic* 'asymmetry'" in international taxation disadvantageous to a foreign entity. (463 U.S. at pp. 194-195 [77 L.Ed.2d at pp. 571-572], italics in original.) Second, the tax method was applied to a domestic corporation rather than to a foreign entity. Finally, stated *Container*, even if foreign nations have a legitimate interest in reducing the tax burden of domestic corporations, that burden results more from tax rate than allocation method, and California can simply raise its tax rate to achieve the same foreign economic effect. (*Ibid.*)

Of course, noted *Container*, the threat of retaliation is not the only foreign policy implication a state tax may have. However, the court also noted there was no amicus curiae brief from the executive branch opposing the tax at issue and setting forth other foreign policy implications. Although not conclusive on the issue, the lack of such a brief did suggest American foreign policy was not seriously threatened by California's worldwide unitary method as applied to domestic-parent groups with foreign subsidiaries. (463 U.S. at pp. 195-196 [77 L.Ed.2d at pp. 572-573].)

The court in *Container* then turned to specific indications of congressional intent in discussing the "clear federal directive" principle and found little there.

No federal statute provided the preemptive force. Although the federal government was bound by numerous tax treaties to use some form of separate accounting in taxing the domestic income of multinational enterprises, that requirement was generally waived regarding the taxes imposed by each of the contracting nations on its own domestic corporations. If nothing else, said the *Container* court, this fact "confirms our view that such taxation is in reality of local rather than international concern." (*Container, supra*, 463 U.S. at p. 196 [77 L.Ed.2d at p. 573].) The tax treaties, moreover, did not generally cover state taxes; none of them prohibited states from using non-separate accounting methods of taxation. The United States Senate had on one occasion declined to give its two-thirds consent to a treaty provision that would have prohibited the states from using such methods. Finally, the court in *Container* noted that Congress had long debated but had not enacted legislation regulating state taxation of income. On this record, the court could not conclude that California's worldwide unitary method as applied to domestic-parent groups with foreign subsidiaries was preempted by federal law or fatally inconsistent with federal policy. (463 U.S. at pp. 196-197 [77 L.Ed.2d at pp. 573-574].)

The last of the three United States Supreme Court decisions critical to our dormant foreign commerce clause analysis is *Wardair Canada v. Florida Dept. of Revenue, supra*, 477 U.S. 1. The court in *Wardair*, however, did not have occasion to apply the dormant foreign commerce clause test created in *Japan Line* and refined in *Container*. This was because the *Wardair* court found it "abundantly clear" that the federal government had

affirmatively acted to permit the state tax at issue there. That tax was levied by Florida and applied to all airline aviation fuel sold within the state regardless of the airliner's destination or the amount of intrastate business the airliner did. (*Id.* at pp. 9, 12 [91 L.Ed.2d at pp. 10, 12].)

The foreign airliner and the United States as amicus curiae in *Wardair* argued there was a federal policy prohibiting Florida's unlimited tax. The policy was allegedly manifested by (1) the 1944 Chicago Convention on International Civil Aviation (1944 Convention), which the United States had signed; (2) a 1966 Resolution of the International Civil Aviation Organization (1966 Resolution), an organization to which the United States belonged; and (3) more than 70 bilateral aviation agreements, including the 1974 U.S.-Canadian Aviation Agreement (Agreement). (Wardair was a Canadian airline.) The *Wardair* court viewed this evidence in a completely different light — in fact, as manifesting a federal policy *permitting* Florida's tax. Accordingly, the dormant foreign commerce clause test of *Japan Line* and *Container* did not come into play — the federal government had made its position clear in permitting such state action. (477 U.S. at pp. 8-12 [91 L.Ed.2d at pp. 9-12].)

The court's analysis was as follows. The 1944 Convention prohibited only state taxation of aviation fuel "'on board an aircraft ... on arrival ... and retained on board on leaving.'" (*Wardair, supra,* 477 U.S. at p. 10 [91 L.Ed.2d at p. 11].) Consequently, according to the court, the international community had considered the issue of state taxation of aviation fuel and had decided to limit only certain state taxes while implicitly preserving the right of states to tax in nonprohibited ways. Although the 1966 Resolution indisputably sought to exempt airline fuel tax from all foreign national and subnational customs and duties, neither the executive branch nor Congress had acted in any way to make the Resolution legally binding. Furthermore, after the 1944 Convention came into

force, the United States entered into more than 70 bilateral aviation agreements; not one of these agreements prohibited states from imposing a Florida-like tax. The 1974 U.S.-Canadian Agreement was limited to "'national duties and charges.'" This limitation was particularly significant, reasoned the *Wardair* court, because the Agreement was entered into eight years after the 1966 Resolution — which addressed the concern of foreign subnational taxation — and because both parties to the Agreement were federalist nations. Finally, during the Agreement, other American states and some Canadian provinces had imposed Florida-like fuel taxes without challenge; this evidenced a course of conduct by the Agreement parties that such taxation was permissible. (*Id.* at pp. 10-12 [91 L.Ed.2d at pp. 11-12].)

According to the court in *Wardair*, "all of this makes abundantly clear" that the federal government has affirmatively acted to permit the states to impose these sales taxes on aviation fuel. (477 U.S. at p. 12 [91 L.Ed.2d at p. 12].) Consequently, the foreign commerce clause test of *Japan Line* and *Container* was inapplicable. (*Ibid.*)

With this background in mind, we turn to the foreign commerce clause issue presented here.

DISCUSSION

1. Does Wardair Apply Here To Preclude A Dormant Foreign Commerce Clause Analysis?

The first issue we must consider is whether the Board is correct that this case is akin to *Wardair* and that there is an affirmative federal policy permitting California to apply the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries. If the Board is correct, such affirmative action by the federal government will end our constitutional analysis because there will be no need to apply the dormant foreign commerce clause framework of *Japan Line*

and *Container*. As we explain, the Board is correct in light of the interpretation of *Wardair* set forth in *Barclays*.

The Board finds such an affirmative federal policy in the following five matters: (1) The United States income tax treaties with foreign countries bind the federal government to use some form of separate accounting but do not similarly bind the states; (2) The executive branch has adopted a Model Income Tax Treaty that does not apply to state taxation and has reserved its position on the Organization of Economic Cooperation and Development (OECD) Model Convention's application to subnational taxes; (3) The United States Friendship, Commerce, and Navigation (FCN) treaties with foreign countries do not contain any state taxation restrictions; (4) Congress has not enacted any legislation prohibiting or restricting state use of the worldwide unitary method; and (5) The United States Senate refused to give its two-thirds consent to article 9(4) in the United States-United Kingdom Tax Treaty, which would have prohibited states from applying the worldwide unitary method to U.K.-parent unitary corporate groups.

These same factors were presented to the court in *Barclays*. The court concluded they were sufficient to invoke the *Wardair* principle, thereby obviating the need to apply a dormant foreign commerce clause analysis.

As the *Barclays* court saw it, *Wardair* "reflects a diminution in the reach of dormant foreign commerce clause analysis in favor of an expanded recognition that, under circumscribed conditions, governmental silence may constitute a ratification of state taxation of foreign commerce, rendering a dormant analysis inapposite." (2 Cal.4th at p. 714.) As *Barclays* explains, "[i]n some cases where Congress affirmatively declines to adopt certain measures, the resulting governmental 'silence' is not the sort that triggers use of a dormant foreign commerce clause analysis." (*Id.* at p. 728.)

In concluding that the factors cited by the Board here were sufficient under *Wardair* to preclude a dormant foreign commerce clause analysis, the *Barclays* court noted that the "Senate's action with respect to article 9(4) is only the most explicit example of a persistent congressional refusal to enact curbs on the states' use of worldwide formula apportionment reaching back well before 1977, the tax year at issue in this case"; that "Congress, after being repeatedly pushed and pulled in both directions, at least for the present has decided *not* to prohibit state use of formula apportionment in cases of this kind"; and that "an extensive pattern of executive branch-negotiated diplomatic texts parallels, in our view, Congress's own unwillingness to disallow legislatively the states' application of formula apportionment methods to foreign-controlled multinational taxpayers, and bespeaks a coordinate 'acquiescence.'" (*Id.* at pp. 733, 736, 738-739, italics in original.)

The *Barclays* court then rendered the following conclusion: "It is clear that federal limitations on the states' use of worldwide formula apportionment is a controversial political and economic issue of which Congress has long been aware. In light of that history, we cannot turn away from the substantial evidence of Congress's repeated refusal to intervene in the regulation of state division of income methods for tax purposes, even one that provokes continuing international complaint. Under the compulsions of established constitutional doctrine, the courts sometimes are required to divine what foreign commerce policy Congress would pursue in the absence of any indication that it has thought about the subject; it is a quite different matter, however, for a court to ignore a pattern of congressional action that evidences both an awareness of an issue and a refusal to adopt the remedy urged upon it by executive officials and resisted by its state constituencies. The latter, we believe, viewed in context alongside additional treaty materials, is a governmental silence that is eloquent. ... [¶] We adhere to the central meaning of the high court's opinion in *Wardair* in holding that Congress's refusal to legislate

restrictions on state use of worldwide formula apportionment is not the sort of governmental silence that triggers a dormant foreign commerce clause analysis." (*Id.* at pp. 741-742.)

Of course, *Barclays* involved the question of whether California's worldwide unitary method of taxation as applied to *foreign*-parent groups was unconstitutional under the foreign commerce clause. Here we deal with the same question as applied to *domestic*-parent groups. Nevertheless, for purposes of whether *Wardair* applies in light of the factors cited by the Board, there is no distinction between this case and *Barclays*. For that reason, we are obligated to adopt the analysis in *Barclays* regarding *Wardair's* applicability. (*Auto Equity Sales, Inc. v. Superior Court* (1962) 57 Cal.2d 450, 455-456 [20 Cal.Rptr. 321, 369 P.2d 937].)

Accordingly, the dormant foreign commerce clause analysis set forth in *Japan Line* and *Container* does not apply here. Congress has acted. "When Congress has struck the balance it deems appropriate, the courts are no longer needed to prevent States from burdening commerce ... Courts are final arbiters under the Commerce Clause only when Congress has not acted." (*Merrion v. Jicarilla Apache Tribe, supra,* 455 U.S. at pp. 154-155 [71 L.Ed.2d at p. 40]; see *Barclays, supra,* 2 Cal.4th at pp. 722, 725, fn. 9.) California's worldwide unitary method of taxation, as applied to domestic-parent groups with foreign subsidiaries, does not violate the foreign commerce clause of the United States Constitution.

2. Did California Unlawfully "Distort" the Amount of Colgate's Income Apportioned to California?

Although Colgate did not file a cross-appeal, it argues the trial court erroneously determined that California's application of the worldwide unitary tax method to Colgate did not unlawfully "distort" the amount of Colgate's income apportioned to California. We denied the Board's motion to strike

this argument from Colgate's respondent's brief. Accordingly, we consider the issue.

Colgate's argument is premised on what *Container* described as the "external consistency" requirement of fairness in an apportionment formula. Under that requirement, the application of a tax apportionment formula, such as California's worldwide unitary tax method, must be fair to pass constitutional scrutiny under both the due process and the commerce clauses; stated another way, the formula must actually reflect a reasonable sense of how income is generated. (*Container, supra,* 463 U.S. at pp. 169-170 [77 L.Ed.2d at pp. 555-556]; *Trinova Corp. v. Michigan Dept. of Treasury* (1991) 498 U.S. ___ [112 L.Ed.2d 884, 111 S.Ct. 818].) Under this constitutional edict, an apportionment formula will be invalidated if the taxpayer can prove by clear and cogent evidence that the income attributed to the state is "'out of all appropriate proportion to the business transacted by the [taxpayer] in that State'" or has "'led to a grossly distorted result.'" (*Container, supra,* 463 U.S. at pp. 170, 181 [77 L.Ed.2d at pp. 556, 563]; *Trinova, supra,* 498 U.S. at p. ___ [112 L.Ed.2d at pp. 908-909].)

In addition to the constitutional "external consistency" requirement, there is a statute in California on the subject. Revenue and Taxation Code section 25137 provides: "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: [¶] (a) Separate accounting; [¶] (b) The exclusion of any one or more of the factors; [¶] (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or [¶] (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Colgate argues that California's worldwide unitary tax method apportioned 70 percent more income to California in comparison to separate accounting and that such apportionment contravenes both the constitutional and the statutory distortion principles. We disagree.

As noted by one commentator in reviewing *Container's* discussion of the constitutional distortion principle of "external consistency," the taxpayer's burden of proof on this issue is "steep if not insurmountable." (23 Columbia Journal at p. 457.) This is an accurate comment. In *Container*, the court noted that the three-factor formula used by California has not only "met our approval" but has become "something of a benchmark against which other apportionment formulas are judged." (463 U.S. at p. 170 [77 L.Ed.2d at p. 556].)

Container also noted the distortion figures in that case were based essentially on separate accounting methods that failed to account for the flow of value between the parts of the unitary business. (*Id.* at pp. 181-184 [77 L.Ed.2d at pp. 563-565].) The same can be said here.

Colgate argues the distortion arises here because Colgate's foreign subsidiaries are substantially more profitable than its California operations. That is, the foreign subsidiaries' lower property, payroll, and sale figures for the same level of productivity result in a distorted apportionment to California under the three-factor formula. In *Container*, the taxpayer made the same argument. The court in *Container* rejected this argument, stating: "The problem with this argument is obvious: the profit figures relied on by [the taxpayer] are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." (463 U.S. at p. 181 [77 L.Ed.2d at p. 563].)

Apparently, there is only one United States Supreme Court decision that has invalidated a state tax apportionment formula applied to a corporate income tax or a franchise tax of a

manufacturing or mercantile company like Colgate. (23 Columbia Journal at pp. 450-451; see also *Container, supra*, 463 U.S. at pp. 182-184 [77 L.Ed.2d at pp. 564-565].) That decision is from 1931 and is entitled *Hans Rees' Sons Inc. v. North Carolina ex rel. Maxwell* (1931) 283 U.S. 123 [75 L.Ed.2d 879, 51 S.Ct. 385]. In that case, a one-factor unitary tax method was applied to a domestic company. Although the company's income in *Hans Rees* was derived from a variety of far-flung activities — including buying, selling and manufacturing — North Carolina's statutory formula allocated the entire wholesale profit to North Carolina, where the manufacturing occurred. This allocation resulted in 250 percent more income attributed to the state. (283 U.S. at pp. 126-128 [75 L.Ed.2d at pp. 889-898]; see 23 Columbia Journal at p. 450; *Container, supra*, 463 U.S. at pp. 183-184 [77 L.Ed.2d at pp. 564-565].)

Colgate's 70 percent figure — which does not account for the flow of value between the parts of Colgate's unitary business — is not comparable to the 250 percent tally in *Hans Rees*. Colgate has not met the steep burden imposed by the constitutional distortion principle of "external consistency.[7]

Colgate realizes this and pins its hopes on Revenue and Taxation Code section 25137. Colgate faces an uphill battle here as well. Under section 25137 and California case law, the Franchise Tax Board is given discretion to select the factors to be used in a tax formula. (*McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506, 512 [72 Cal.Rptr. 465, 446 P.2d 313].) Where a taxpayer petitions for an alternative formula under section 25137, the taxpayer bears the burden of establishing by clear and convincing evidence that the formula used by the Franchise Tax Board reaches an unreasonable result in

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[7] In a recent decision, the United States Supreme Court relied on *Container's* flow of value concept to uphold the application of the three-factor formula involved here to a value added tax on a unitary business. (*Trinova, supra*, 498 U.S. ___ [112 L.Ed.2d 884].)

his or her case. (*Ibid.*; Rev. & Tax. Code, § 25137; *Communications Satellite Corp. v. Franchise Tax Bd.* (1984) 156 Cal.App.3d 726, 746-749 [203 Cal.Rptr. 779]; see e.g., *Firestone Tire & Rubber Co. v. County of Monterey* (1990) 223 Cal.App.3d 382, 387-388 [272 Cal.Rptr. 745].)

Colgate argues that the trial court used the constitutional "out of all proportion" test to dismiss Colgate's statutory assertion under section 25137. Additionally, Colgate argues that testimony from the Board's counsel for multi-state tax affairs establishes that the Board unlawfully fails to consider separate accounting as an alternative for unitary companies under section 25137. The first of these arguments is meritless, rendering a discussion of the second unnecessary.

As noted by the Board, the trial court did not apply the constitutional "out of all proportion" test to the statutory issue. In reviewing the Board's denial of Colgate's section 25137 petition, the trial court cited *Container*'s "flow of value" concept and upheld the Board's determination that Colgate had not demonstrated by clear and convincing evidence that California's apportionment formula unfairly represented the extent of Colgate's business activity in California. (*Container, supra*, 463 U.S. at pp. 181-184 [77 L.Ed.2d at pp. 563-565].) This constituted a correct application of the statutory standard set forth in section 25137. (*McDonnell Douglas Corp. v. Franchise Tax Bd., supra*, 69 Cal.2d at p. 512; see *Amoco Production Company v. Armold* [sic] (1974) 213 Kan. 636 [518 P.2d 453, 463-465].)

Citing *Hunt-Wesson Foods, Inc. v. County of Alameda* (1974) 41 Cal.App.3d 163, 176 [116 Cal.Rptr. 160], Colgate contends the right to recover taxes paid under protest is a fundamental vested right; therefore, the trial court was obligated to exercise its independent judgment on the section 25137 evidence. We disagree with Colgate for two reasons. First, the *Hunt-Wesson* court did not hold that the right to recover taxes paid under

protest is a fundamental vested right. That court said the argument could be made. (41 Cal.App.3d at p. 176.) Second, and more importantly, the precise issue involved here concerns the application of a particular tax method that is within the discretion of the Franchise Tax Board under statutory directive. (*McDonnell Douglas Corp. v. Franchise Tax Bd., supra*, 69 Cal.2d at p. 512; Rev. & Tax. Code, §§ 25120-25139; Cal. Code Regs., tit. 18, § 25137-6; see *Amoco Production Company v. Arnold, supra*, 518 P.2d at pp. 463-465; see, e.g., *Firestone Tire & Rubber Co. v. County of Monterey, supra*, 223 Cal.App.3d at pp. 387-388.) Colgate can hardly ascribe an individually "vested" status to this process. (See *Hunt-Wesson, supra* 41 Cal.App.3d at p. 174.) As noted, *McDonnell Douglas* is the relevant decision on this limited issue. (69 Cal.2d at p. 512.)

Our resolution of the statutory distortion issue renders irrelevant Colgate's argument that the Board unlawfully fails to consider separate accounting as an alternative for unitary companies under section 25137. Colgate has not shown that California's apportionment formula unfairly represented the extent of Colgate's business activity in California. The alternatives set forth in section 25137 are invoked only if the taxpayer makes that showing. Consequently, we do not address this argument.

3. The Sanctions and Costs Issues

The Board claims the trial court abused its discretion in denying the Board's motion for sanctions against Colgate. In that motion, the Board argued that Colgate unduly delayed in producing certain documents evidencing the unitary nature of Colgate's operations.

This matter arose when Colgate, during the first two days of trial, belatedly produced to the Board's counsel five boxes of documents pursuant to the Board's requests for production of documents and a court order based on those requests. Included in this belated production were documents relevant

to the operation of Colgate's Danish subsidiary and therefore relevant to the issue of whether Colgate's subsidiaries operated in a unitary fashion with the domestic parent corporation. This production occurred in mid-July 1988. It was not until mid-February 1989, however, that the Board moved for sanctions on this matter; this was after the trial was over and after the Board had won on the unitary issue. On these facts, the trial court declined to award sanctions because the motion was untimely and failed to evidence prejudice against the Board.

The trial court has broad discretion in imposing discovery sanctions, subject to reversal only for arbitrary, capricious or whimsical action. (See *Sauer v. Superior Court* (1987) 195 Cal.App.3d 213, 228 [240 Cal.Rptr. 489]; *Kahn v. Kahn* (1977) 68 Cal.App.3d 372, 380-381 [137 Cal.Rptr. 332] [although these cases were not decided under the current discovery statutes, the general principle of review they enunciate remains valid. (See former Code Civ. Proc., § 2034.)].) Code of Civil Procedure section 2023, subdivision (b)(1), upon which the Board relies, does not alter this well-settled principle and the Board concedes as much. That section and subdivision provides in pertinent part that "[i]f a monetary sanction is authorized by any provision of this article, the court shall impose that sanction unless it finds that the one subject to the sanction acted with substantial justification or that other circumstances make the imposition of the sanction unjust."

The Board argues that the trial court's finding of no prejudice conveys the message that it is acceptable to abuse discovery and conceal evidence, so long as the party seeking discovery cannot prove how those actions prejudiced its case. Of course, prejudice is difficult to prove in the face of victory. The Board's real concern is that such discovery abuse will go unpunished. The Board can rest assured that the trial court possesses an array of weapons to counter parties abusing the discovery process. These weapons include a "Monetary sanction," an "Issue sanction," an "Evidence sanction," a

"Terminating Sanction," and a "Contempt Sanction." (Code Civ. Proc., § 2023, subd. (b)(1)(2)(3)(4)(5).) The problem for the Board here is that a timely motion for sanctions is required to make these sanctions effective. The Board made its motion after the trial was over and after it had won on the issue for which it sought sanctions. And the Board cannot claim it did not know about the discovery abuse until it made its motion in February 1989. The Board admits it uncovered the abuse in July 1988 during the first days of trial.

The Board argues it was prejudiced because it could have moved for summary judgment on the unitary issue had the documents been timely produced, and the trial could have been shortened if not eliminated. We doubt seriously that operational documents concerning one of Colgate's 75 foreign subsidiaries were the only evidence standing in the way of a summary judgment motion on the unitary issue. In any event, the nature of the unitary issue is essentially factual and particular to the corporate enterprise being examined. For that reason, the issue would not usually be amenable to summary adjudication resolution.[8] We also doubt that Colgate's timely production could have eliminated or significantly shortened the trial. The testimony part of the trial also encompassed the distortion issues, and the heart of the lawsuit concerned the foreign commerce clause issue.

The trial court did not abuse its discretion in denying the Board's motion for discovery sanctions.

Our partial reversal of the judgment resolves the issue of costs awarded below to Colgate. Under our decision, Colgate is no longer the prevailing party and is therefore not entitled to costs.

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[8] We note that, with certain exceptions, Code of Civil Procedure section 437c was amended in 1990 to eliminate motions for summary adjudication of issue(s).

DISPOSITION

The portion of the judgment regarding the foreign commerce clause issue is reversed. The portion of the judgment regarding the constitutional and statutory distortion issues and on the matter of sanctions is affirmed. The Board is awarded its costs on appeal.

Puglia, P.J., and Sparks, J., concurred.

APPENDIX C

COLGATE-PALMOLIVE COMPANY,
Respondent,

v.

FRANCHISE TAX BOARD,
Appellant.

No. S023147.

Supreme Court of the State of California,
in Bank.

June 18, 1992.

Prior report: Cal.App., 284 Cal.Rptr. 780.

The above-entitled cause is transferred to the Court of Appeal, Third Appellate District, with directions to vacate its decision and to refile the opinion after modification in light of *Barclays Bank International v. Franchise Tax Board* (1992) 2 Cal.4th 708, 8 Cal.Rptr.2d 31, 829 P.2d 279.

The Reporter of Decisions is directed to publish the opinion in the above-entitled case, as modified, in the Official Reports. See subdivision (c) of rule 978, California Rules of Court.

LUCAS, C.J., and MOSK, PANELLI, KENNARD, ARABIAN, BAXTER and GEORGE, J.J., concur.

APPENDIX D

COLGATE-PALMOLIVE COMPANY,
Respondent,

v.

FRANCHISE TAX BOARD,
Appellant.

No. S023147.

Supreme Court of the State of California,
in Bank.

Nov. 27, 1991.

Prior report: Cal.App., 284 Cal.Rptr. 780.

Respondent's petition for review GRANTED.

MOSK, PANELLI, KENNARD, ARABIAN, BAXTER and GEORGE, J.J., concur.

APPENDIX E

COLGATE-PALMOLIVE COMPANY,
Plaintiff and Respondent,

v.

FRANCHISE TAX BOARD,
Defendant and Appellant

No. C007044.

Court of Appeal of the State of California,
Third Appellate District.

Aug. 20, 1991.

DAVIS, Associate Justice.

The principal issue in this appeal is whether California's worldwide unitary method of taxation (based on Rev. & Tax. Code, § 25101, 25120-25139), as applied to domestic-parent unitary corporate groups, is unconstitutional under the foreign commerce clause of the United States Constitution. (U.S. Const., art. I, § 8, cl. 3.)[1] Using the legal framework set forth in

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[1] During the tax years at issue (1970-1973), Revenue and Taxation Code section 25101 provided in pertinent part: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter);..."

California's version of the Uniform Division of Income for Tax Purposes Act (UDITPA), is contained in Article 2. That Act provides for formula apportionment of the net income from business activities both within and

Footnote continued...

Container Corp. v. Franchise Tax Bd. (1983) 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545, we conclude the tax method does not violate that clause. We therefore reverse in part the trial court's judgment.

BACKGROUND

The Methods of Allocating Income

When a corporation, either on its own or through subsidiaries, conducts business across state or national boundaries, the allocation of income to each relevant jurisdiction becomes an issue. To resolve this issue, two methods of income allocation have been created: the arm's length/separate accounting method and the unitary business/formula apportionment method. In reality, these methods simply highlight a general distinction: there are many different ways of specifically applying either of them. (*Container Corp. v. Franchise Tax Bd.*, supra, 463 U.S. at pp. 182, 191, 196, 103 S.Ct. at pp. 2949, 2954, 2956; Langbein, 23 Tax Notes (1986) 625, 626; Note, *State Worldwide Unitary Taxation: The Foreign Parent Case* (1985) 23 Columbia Journal of Transnational Law 445, 451, hereafter 23 Columbia Journal.)

Under separate accounting, the related corporations of a multijurisdictional enterprise are viewed as distinct from one another; taxable income is determined separately for each individual corporation by the jurisdiction in which that corporation actually conducts business or has a permanent establishment. Any improper shifting of value between the related corporations to avoid taxes is corrected by requiring "arm's

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outside California in order to reach the net income attributable to California activities. (Rev. & Tax.Code, §§ 25120-25139.)

In 1982, section 25101 was amended in a manner insignificant to our purposes. (Stats. 1982, ch. 466, § 104, p. 2055.)

length" pricing in related corporate transactions. In other words, the related corporations must act as if they were unrelated entities dealing at arm's length in the marketplace.

In contrast, under the unitary business/formula apportionment method of allocating income at issue in this case — the worldwide unitary method — the related corporations of a multijurisdictional enterprise are treated as units of a single business — that is, as a "unitary group." (Cal.Code Regs., tit. 18, § 25137-6.)[2] If a corporation doing business in California is deemed to be part of a unitary group, the total income for that group worldwide, including corporations operating wholly outside the United States, is apportioned to California by a three-factor formula. Under the formula, the property, payroll, and sales figures for the group in California are arithmetically compared to the property, payroll, and sales figures for the group worldwide. (See Rev. & Tax.Code, § 25128-25136.) This comparison results in a proportion that is multiplied against the unitary group's worldwide income, producing an apportioned amount of such income taxable by California.[3] Simply put, if 25 percent of the property, payroll, and sales of the unitary group is located in California, then 25 percent of the group's worldwide income is apportioned to California. Under this method, it is unnecessary to make "arm's length"

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[2] Generally, a corporation is included within the unitary group if its activities outside California are dependent upon or contribute to the business of a related corporation within California. (See *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 183 P.2d 16.)

[3] The amount of the unitary group's income taxable by California is calculated as follows:

$$\frac{\frac{\text{In-State Property}}{\text{Total Property}} + \frac{\text{In-State Payroll}}{\text{Total Payroll}} + \frac{\text{In-State Sales}}{\text{Total Sales}}}{3} \times \begin{matrix}\text{Unitary}\\ \text{Group's Total}\\ \text{Worldwide}\\ \text{Income}\end{matrix} = \text{Income Taxable by California}$$

(Rev. & Tax. Code, §§ 25128-25137; 23 Columbia Journal at p. 445, fn. 2.)

corrections because intercorporate transactions are disregarded.

Aside from a few minor exceptions, the income allocation method used by the United States and all of the other nations of the world is the separate accounting method, although, as noted, this method varies in practice. However, the United States has basically limited the application of its tax treaties to federal taxes. (*Container Corp. v. Franchise Tax Bd.*, supra, 463 U.S. at p. 196, 103 S.Ct. at p. 2956.)[4]

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[4] California in 1986 passed legislation, effective January 1, 1988, permitting taxpayers to make a "water's-edge election" notwithstanding Revenue and Taxation Code section 25101 (Rev. & Tax.Code, § 25110 et seq.).

This "water's-edge" method restricts tax allocation methods to the United States as the jurisdictional boundary, and offers an alternative to the worldwide unitary method for determining taxable income. (See Rev. & Tax.Code, §§ 25101, 25110.) Rather than accounting for the income and apportionment factors (property, payroll, and sales) of all the corporations of its worldwide unitary group, a corporate taxpayer making such an election accounts for the income and apportionment factors of the following entities affiliated with it, subject to some minor exceptions: corporations incorporated in the United States; any corporation, wherever incorporated, if the average of its apportionment factors within the United States is 20 percent or more; affiliated corporations which are eligible to be included in a federal consolidated tax return; domestic international sales corporations and foreign sales corporations engaged in sales in the United States; export trade corporations; any corporation not mentioned above but only to the extent of income derived from or attributable to sources within the United States; and any affiliated corporation which is a controlled foreign corporation as defined in the Internal Revenue Code. Any corporation not subjected to the worldwide unitary method under Revenue and Taxation Code section 25101 need not be included in this "water's-edge" accounting. (Rev. & Tax.Code, § 25110, subd. (a).)

In general, this election permits a taxpayer corporation to exclude the income and apportionment factors of foreign subsidiaries from the corporation's California tax base. An accounting restriction to the water's edge of the United States in the present context would mean that California could rely only on income derived from permanent establishments of Colgate in the United States, and not on income derived from wholly foreign interests, to calculate Colgate's franchise tax.

Footnote continued...

The present controversy involves Colgate-Palmolive Company, Inc. (Colgate), a domestic-parent unitary corporate group with approximately 75 foreign subsidiaries operating in about 54 foreign counties [sic].[5] Colgate was directed to pay additional taxes for the years 1970 through 1973 after California applied the worldwide unitary tax method to the group. Under protest, Colgate paid the additional taxes and this suit ensued.

The Issues on Appeal

At trial, Colgate challenged the federal constitutionality of these additional taxes on foreign commerce clause grounds. The thrust of Colgate's argument below was that the federal executive branch acted decisively after the *Container* decision

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To qualify for the "water's-edge" election, the corporate taxpayer must (1) consent to the taking of depositions from key corporate personnel and to the production of documents to ensure the Franchise Tax Board has the information necessary to make genuine arm's length adjustments and unitary business investigations, and (2) agree that dividends received by any affiliated entity from corporations significantly related to the unitary business constitute business income of the taxpayer. (Rev. & Tax. Code, § 25110, subd. (b)(2).) Additionally, to qualify the corporate taxpayer must enter into a five-year contract with the Franchise Tax Board, pay an annual fee, and subject itself to various conditions. (Rev. & Tax.Code, §§ 25111-25115.)

A domestic-parent multinational corporation that does not make this election is subjected essentially to the 1970-1973 taxation method at issue here. (*See* fn. 1, *ante*.) We emphasize, however, that the principal issue in this case is the foreign commerce clause constitutionality of California's worldwide unitary tax method as applied to domestic-parent unitary corporate groups with foreign subsidiaries (Rev. & Tax.Code, § 25101 et seq.). Because California's "water's-edge election" is not involved in this case, we do not express any views regarding it. (Rev. & Tax.Code, § 25110 et seq.)

[5] Reversing its position below, Colgate on appeal does not dispute that it is a domestic-parent unitary corporate group.

to communicate its longstanding position that California's worldwide unitary tax method impermissibly interferes with American foreign policy; according to Colgate, this decisive action eliminated the factual ambiguity that resulted in the *Container* decision. The trial court agreed with this argument and determined that California's worldwide unitary tax method was unconstitutional on this ground. The Franchise Tax Board (the Board) appeals that decision here.

Colgate also argued at trial that California's three-factor unitary formula unlawfully "distorted" the amount of Colgate's income apportioned to California. The trial court found against Colgate on this issue, which Colgate again raises in its respondent's brief.[6]

Finally, two peripheral issues are raised by the Board in this appeal. First, the Board claims the trial court abused its discretion in denying the Board's motion for discovery sanctions. Secondly, the Board asserts the court below erroneously awarded certain costs to Colgate.

The Foreign Commerce Clause

Article I, section 8, clause 3 of the United States Constitution empowers Congress "To regulate commerce with foreign nations, and among the several states, and with the Indian tribes." As the United States Supreme Court has long emphasized, this clause limits the power of the States even in the absence of Congressional legislation. (*Boston Stock Exchange v. State Tax Comm'n.* (1977) 429 U.S. 318, 328, 97 S.Ct. 599, 606, 50 L.Ed.2d 514, 523; *Freeman v. Hewit* (1946) 329 U.S. 249, 252, 67 S.Ct. 274, 276, 91 L.Ed. 265, 271.) In this respect, the commerce clause indirectly allocates the relative powers of states and the federal government. (*Star-Kist Foods, Inc. v. County of*

[6] The Board moved to strike this argument on appeal, contending it was improperly raised in these proceedings. We denied the Board's motion.

Los Angeles (1986) 42 Cal.3d 1, 9, 227 Cal.Rptr. 391, 719 P.2d 987.)

As noted in *Star-Kist*, "[d]etermining whether a state tax exceeds the bounds of permissible state action under the [commerce] clause is often a difficult task." (42 Cal.3d at p. 10, 227 Cal.Rptr. 391, 719 P.2d 987.) In the context of the foreign commerce clause, there are three United States Supreme Court decisions that have delineated the test under which this determination is made: *Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434, 99 S.Ct. 1813, 60 L.Ed.2d 336; *Container Corp. v. Franchise Tax Bd.*, supra, 463 U.S. 159, 103 S.Ct. 2933; and *Wardair Canada v. Florida Dept. of Revenue* (1986) 477 U.S. 1, 106 S.Ct. 2369, 91 L.Ed.2d 1.

Applying the foreign commerce clause test it created, the court in *Japan Line* held that instrumentalities of commerce — in that case, seagoing cargo containers — which are foreign-owned, -based, and -registered and which are used solely in international commerce may not be subjected to a state's apportioned ad valorem property tax. (441 U.S. at pp. 436, 444, 99 S.Ct. at pp. 1815, 1819.)

In creating the foreign commerce clause test, the *Japan Line* court noted that the issue of taxation between nations is more complicated than the issue of taxation between American states. This increased complexity results from a number of factors, including the greater sensitivity to national as opposed to state sovereignty, the lack of an authoritative tribunal capable of resolving transnational disputes, and the fact that actions by individual states can work to the detriment of the whole country. (441 U.S. at pp. 447-451, 456, 99 S.Ct. at pp. 1820-1823, 1825.) In light of these circumstances, said *Japan Line*, the foreign commerce power of Congress is greater than its interstate commerce power and the need for one national voice in regulating commercial relations with foreign nations is paramount. (*Id.* at pp. 448-449, 99 S.Ct. at pp. 1821-1822.)

From this comparison of the interstate and the foreign contexts, the foreign commerce clause test was born. That test was engendered by adding two inquiries onto the already existing four-part test for interstate commerce clause review. (*Japan Line*, supra, 441 U.S. at pp. 444-445, 451, 99 S.Ct. at pp. 1819-1820, 1823.)

Under the four-part interstate test, a state tax will survive an interstate commerce clause challenge if the tax "'[i] is applied to an activity with a substantial nexus with the taxing State, [ii] is fairly apportioned, [iii] does not discriminate against interstate commerce, and [iv] is fairly related to the services provided by the State.'" (*Japan Line, supra*, 441 U.S. at pp. 444-445, 449, 454, 99 S.Ct. at pp. 1819-1820, 1822, 1824, quoting *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, 279, 97 S.Ct. 1076, 51 L.Ed.2d 326.)

The two additional inquiries prompted by the foreign context are: first, whether the tax creates a "substantial risk of international multiple taxation" (441 U.S. at p. 451, 99 S.Ct. at p. 1823); and, second, whether the tax "may impair federal uniformity in an area where federal uniformity is essential" (*Id.* at p. 448, 99 S.Ct. at p. 1821), and prevents "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" (*Id.* at p. 451, 99 S.Ct. at p. 1823, quoting *Michelin Tire Corp. v. Wages* (1976) 423 U.S. 276, 285, 96 S.Ct. 535, 540, 46 L.Ed.2d 495; see also *Container, supra*, 463 U.S. at pp. 193-194, 103 S.Ct. at pp. 2954-2955.) If a state tax violates either of these precepts, it is unconstitutional under the foreign commerce clause. (*Id.* 441 U.S. at p. 451, 99 S.Ct. at p. 1823.)

Because the foreign commerce clause is self-executing, the judiciary applies this test when Congress or the federal government has not acted or purported to act. (*Merrion v. Jicarilla Apache Tribe* (1982) 455 U.S. 130, 154-155, 102 S.Ct. 894, 910-911, 71 L.Ed.2d 21; *Wardair, supra*, 477 U.S. at pp. 7-8, 18, 106 S.Ct.

at pp. 2372-2373, 2378.) In such "dormant" foreign commerce clause situations, the judiciary must determine whether a particular state action unduly threatens the purpose of the clause: to ensure a unified national voice in foreign commerce matters raising inherently national concerns and to ensure that individual states do not work to the detriment of the whole nation. (*Ibid.*; see also *Japan Line, supra*, 441 U.S. at pp. 448-449, 99 S.Ct. at pp. 1821-1822.)

In *Japan Line*, the state tax at issue was found to violate both of the additional foreign commerce clause considerations. Multiple taxation resulted because the foreign country involved, Japan, taxed the cargo containers at full value. (441 U.S. at pp. 451-452, 99 S.Ct. at pp. 1823-1824.) The "one-voice" standard was violated because the United States and Japan had signed a convention reflecting a national policy to preclude such taxes. Furthermore, American-owned cargo containers were not taxed in Japan; this created an asymmetry in international taxation disadvantageous to Japan and, under such circumstances, the risk of Japanese retaliation against the whole nation was substantial. Finally, if other states enacted their own taxing schemes, taxation would vary port-by-port, making speaking with one voice impossible. (*Id.* at pp. 452-453, 99 S.Ct. at pp. 1823-1824.)

That brings us to the decision in *Container Corp. v. Franchise Tax Bd.*, supra, 463 U.S. 159, 103 S.Ct. 2933. The importance of the *Container* decision to our analysis cannot be overstated. *Container* involved the precise issue presented here: the constitutionality under the foreign commerce clause of California's worldwide unitary tax method as applied to a domestic-parent unitary corporate group (hereafter, domestic-parent group) with foreign subsidiaries. (*Id.* at pp. 163, 171, 103 S.Ct. at pp. 2939, 2943.) Applying essentially the dormant foreign commerce clause test set forth in *Japan Line*, the court in *Container* held the tax method constitutional. (*Id.* at pp. 185-197, 103 S.Ct. at pp. 2950-2957.)

Initially, *Container* noted the similarities and differences between itself and *Japan Line*. Similar to *Japan Line*, in *Container* actual double taxation had occurred, such taxation resulted from a serious divergence between California and foreign taxing methods, and the foreign taxing methods accorded with the international practice of separate accounting. At this point, *Container* added: "... our own Federal Government, to the degree it has spoken, seems to prefer the taxing method adopted by the international community to the taxing method adopted by California." (463 U.S. at p. 187, 103 S.Ct. at p. 2952.) Unlike *Japan Line*, the tax in *Container* was on income rather than on property, double taxation did not inevitably result from California's worldwide unitary method, and the tax fell on a corporation domiciled and headquartered in the United States rather than on foreign owners. (*Id.* at pp. 187-188, 103 S.Ct. at pp. 2951-2952.) At this point, *Container* noted "[w]e have no need to address in this opinion the constitutionality of [the worldwide unitary method] with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." (*Id.* at p. 189, fn. 26, 103 S.Ct. at p. 2952-2953, fn. 26.)

In applying *Japan Line*'s first additional foreign commerce clause consideration — the enhanced risk of international multiple taxation — *Container* noted that separate accounting did not inevitably end double taxation and California's worldwide unitary method did not inevitably lead to it. Given this state of affairs, said *Container*, it would be perverse constitutionally to require one method of taxation over another when both could result in a double tax. (463 U.S. at pp. 189-193, 103 S.Ct. at pp. 2952-2953.)

Container refined *Japan Line*'s second additional foreign commerce clause consideration — the "one voice" standard — by stating: "In conducting this inquiry, ... we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some

explicit directive from Congress, ... that treatment of foreign income at the federal level mandates identical treatment by the States.' [Citations.] Thus, a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive. The second of these considerations is, of course, essentially a species of preemption analysis." (463 U.S. at p. 194, 103 S.Ct. at p. 2955, emphasis in original.)

According to *Container*, the most obvious foreign policy implication of a state tax is the threat it might pose of offending foreign trading partners, leading them to retaliate against the whole nation. The court in *Container* noted that the judiciary has little competence in making this determination and emphasized that the nuances of foreign policy "are much more the province of the Executive Branch and Congress than of this Court." (463 U.S. at pp. 194, 196, 103 S.Ct. at pp. 2955, 2956.) The best a court can do, said *Container*, is try to develop objective standards reflecting general observations about international trade and relations. (*Id.* at p. 194, 103 S.Ct. at p. 2955.)

Doing just that, the court in *Container* set forth three reasons that weighed strongly against the possibility of justifiable and significant foreign retaliation. First, California's worldwide unitary tax method as applied to domestic-parent groups did not create an *"automatic* 'asymmetry'" in international taxation disadvantageous to a foreign entity. (463 U.S. at pp. 194-195, 103 S.Ct. at pp. 2955-2956, emphasis in original.) Second, the tax method was applied to a domestic corporation rather than to a foreign entity. Here again, *Container* emphasized the domestic versus foreign construct, adding that a tax falling on a domestic corporation "might be less significant in the case of a domestic corporation that was owned by foreign interests." (*Id.* at p. 195, fn. 32, 103 S.Ct. at p. 2956.) Finally, stated *Container*, even if foreign nations have a legitimate interest in reducing the tax burden of domestic corporations,

that burden results more from tax rate than allocation method, and California can simply raise its tax rate to achieve the same foreign economic effect. (*Ibid.*)

Of course, noted *Container*, the threat of retaliation is not the only foreign policy implication a state tax may have. However, the court also noted there was no amicus curiae brief from the executive branch opposing the tax at issue and setting forth other foreign policy implications. Although not conclusive on the issue, the lack of such a brief did suggest American foreign policy was not seriously threatened by California's worldwide unitary method as applied to domestic-parent groups with foreign subsidiaries. (463 U.S. at pp. 195-196, 103 S.Ct. at pp. 2955-2956.) The court did note the solicitor general had submitted a brief opposing state use of the worldwide unitary method in a domestic corporation case argued the previous term and carried over to the present term. Nevertheless, said the court, there was no indication that the position set forth in the solicitor general's brief still represented the government's view or that the solicitor general's brief should apply to the *Container* case. (*Id.* at p. 195, fn. 33, 103 S.Ct. at p. 2956, fn. 33.)

The court in *Container* then turned to specific indications of congressional intent in discussing the "clear federal directive" principle and found little there.

No federal statute provided the preemptive force. Although the federal government was bound by numerous tax treaties to use some form of separate accounting in taxing the domestic income of multinational enterprises, that requirement was generally waived regarding the taxes imposed by each of the contracting nations on its own domestic corporations. If nothing else, said the *Container* court, this fact "confirms our view that such taxation is in reality of local rather than international concern." (*Container, supra,* 463 U.S. at p. 196, 103 S.Ct. at p. 2956.) The tax treaties, moreover, did

not generally cover state taxes; none of them prohibited states from using non-separate accounting methods of taxation. The United States Senate had on one occasion declined to give its two-thirds consent to a treaty provision that would have prohibited the states from using such methods. Finally, the court in *Container* noted that Congress had long debated but had not enacted legislation regulating state taxation of income. On this record, the court could not conclude that California's worldwide unitary method as applied to domestic-parent groups with foreign subsidiaries was preempted by federal law or fatally inconsistent with federal policy. (463 U.S. at pp. 196-197.)

The last of the three United States Supreme Court decisions critical to our dormant foreign commerce clause analysis is *Wardair Canada v. Florida Dept. of Revenue*, supra, 477 U.S. 1, 106 S.Ct. 2369. The court in *Wardair*, however, did not have occasion to apply the dormant foreign commerce clause test created in *Japan Line* and refined in *Container*. This was because the *Wardair* court found it "abundantly clear" that the federal government had affirmatively acted to permit the state tax at issue there. That tax was levied by Florida and applied to all airline aviation fuel sold within the state regardless of the airliner's destination or the amount of intrastate business the airliner did. (*Id.* at pp. 9, 12, 106 S.Ct. at pp. 2373, 2375.)

The foreign airliner and the United States as amicus curiae in *Wardair* argued there was a federal policy prohibiting Florida's unlimited tax. The policy was allegedly manifested by (1) the 1944 Chicago Convention on International Civil Aviation (1944 Convention), which the United States had signed; (2) a 1966 Resolution of the International Civil Aviation Organization (1966 Resolution), an organization to which the United States belonged; and (3) more than 70 bilateral aviation agreements, including the 1974 U.S.-Canadian Aviation Agreement (Agreement). (Wardair was a Canadian airline.) The *Wardair* court viewed this evidence in a completely different light — in fact, as manifesting a federal policy

permitting Florida's tax. Accordingly, the dormant foreign commerce clause test of *Japan Line* and *Container* did not come into play — the federal government had made its position clear in permitting such state action. (477 U.S. at pp. 8-12, 106 S.Ct. at pp. 2373-2375.)

The court's analysis was as follows. The 1944 Convention prohibited only state taxation of aviation fuel "'on board an aircraft ... on arrival ... and retained on board on leaving.'" (*Wardair, supra*, 477 U.S. at p. 10, 106 S.Ct. at p. 2374.) Consequently, according to the court, the international community had considered the issue of state taxation of aviation fuel and had decided to limit only certain state taxes while implicitly preserving the right of states to tax in nonprohibited ways. Although the 1966 Resolution indisputably sought to exempt airline fuel tax from all foreign national and subnational customs and duties, neither the executive branch nor Congress had acted in any way to make the Resolution legally binding. Furthermore, after the 1944 Convention came into force, the United States entered into more than 70 bilateral aviation agreements; not one of these agreements prohibited states from imposing a Florida-like tax. The 1974 U.S.-Canadian Agreement was limited to "'national duties and charges.'" This limitation was particularly significant, reasoned the *Wardair* court, because the Agreement was entered into eight years after the 1966 Resolution — which addressed the concern of foreign subnational taxation — and because both parties to the Agreement were federalist nations. Finally, during the Agreement, other American states and some Canadian provinces had imposed Florida-like fuel taxes without challenge; this evidenced a course of conduct by the Agreement parties that such taxation was permissible. (*Id.* at pp. 10-12, 106 S.Ct. at pp. 2374-2375.)

According to the court in *Wardair*, "all of this makes abundantly clear" that the federal government has affirmatively acted to permit the states to impose these sales taxes on aviation fuel. (477 U.S. at p. 12, 106 S.Ct. at p. 2375.) Consequently, the foreign commerce clause test of *Japan Line* and *Container* was inapplicable. (*Ibid.*)

With this background in mind, we turn to the foreign commerce clause issue presented here.

DISCUSSION

1. Does Wardair Apply Here To Preclude A Dormant Foreign Commerce Clause Analysis?

The first issue we must consider is whether the Board is correct that this case is akin to *Wardair* and that there is an affirmative federal policy permitting California to apply the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries. If the Board is correct, such affirmative action by the federal government will end our constitutional analysis because there will be no need to apply the dormant foreign commerce clause test of *Japan Line* and *Container*. As we explain, however, the Board is not correct.

The Board finds such an affirmative federal policy in the following five matters: (1) The United States income tax treaties with foreign countries bind the federal government to use some form of separate accounting but do not similarly bind the states; (2) The executive branch has adopted a Model Income Tax Treaty that does not apply to state taxation and has reserved its position on the Organization of Economic Cooperation and Development (OECD) Model Convention's application to subnational taxes; (3) The United States Friendship, Commerce, and Navigation (FCN) treaties with foreign countries do not contain any state taxation restrictions; (4) Congress has not enacted any legislation prohibiting or restricting state use of the worldwide unitary method; and (5) The United States Senate rejected article 9(4) in the United States-United Kingdom Tax Treaty, which would have prohib-

ited states from applying the worldwide unitary method to U.K.-parent unitary corporate groups.

The treaties and treaty actions set forth in (1) through (3) above do not support the Board's *Wardair* position. This is because those treaties and actions, aside from the U.S.-U.K. Tax Treaty which we discuss shortly, either do not consider state taxation at all or do so in only the most general way. Not one of the treaties or actions, with the exception noted, specifically addresses state use of the worldwide unitary method. The affirmative federal policy expressed in these treaties and actions is the general principle of preserving state sovereignty rather than the specific principle of permitting states to use the worldwide unitary method.

The Board argues that since the bilateral income tax treaties bind only the federal government, and not the states, to use some form of separate accounting, that constitutes, under *Wardair*, "an omission which must be understood as representing a policy choice ..." permitting state use of the worldwide unitary method. (477 U.S. at p. 11, 106 S.Ct. at p. 2374.) This argument fails for two reasons. First, as noted previously, these tax treaties either do not consider the issue of state taxation at all or do so in only the most general fashion. It cannot be argued seriously that *policy choices* regarding methods of state taxation are being made in this climate. Second, and more specifically, there are many different separate accounting methods and many different unitary accounting methods. (*Container, supra*, 463 U.S. at pp. 182, 191, 196, 103 S.Ct. at pp. 2949, 2954, 2956; Langbein, 23 Tax Notes, supra, at p. 626; 23 Columbia Journal at p. 451.) Accordingly, just because an income tax treaty commits the federal government to a particular form of separate accounting does not automatically mean the states can use the worldwide unitary method. Again, the limitation to the federal government, in this context, is a general limitation to preserve state sovereignty and not a specific affirmation of state use of the worldwide unitary method.

Nor can much affirmative action be discerned from the *absence* of congressional legislation prohibiting or restricting state use of the worldwide unitary method. Under the Board's argument, we are to presume that Congress has affirmatively stated its position through silence. We are unpersuaded. It is just as easy to say that the *absence* of congressional legislation allowing the states to use the worldwide unitary method affirmatively indicates that Congress does not want the states to use that method. Furthermore, how is a court to construe legislative silence? In this context, affirmative legislative silence is an oxymoronic concept which sheds no light on the issue.

That leaves the fifth factor — the United States Senate action on the U.S.-U.K. Tax Treaty.

This treaty was signed by the executive branch in 1975 and contained a provision — article 9(4) — that would have prohibited states from applying the worldwide unitary method to U.K.-parent groups. The United States Senate ratified the treaty only after article 9(4) was in effect deleted through a reservation by Senator Church.

The problem for the Board regarding this matter is that Senator Church's reservation was defeated in committee and on the senate floor, and the treaty with article 9(4) included was voted upon favorably by a margin of 49 to 32. True, the treaty fell 5 votes short of the two-thirds majority needed for ratification and was ratified only after the Church reservation was exhumed without a vote. But, three Senate majorities approving article 9(4) hardly argue for the proposition that Congress has affirmatively acted to permit the states to use the worldwide unitary method.

In its opening brief, the Board argues the Senate action on article 9(4) indicated a congressional policy permitting states to use the worldwide unitary method because the executive branch has never again negotiated an income tax treaty — ratified by the Senate — which either restricted or prohibited

state use of the worldwide unitary method. However, the answer to this argument is found on the very next page of the Board's brief, where the Board acknowledges that "[t]he Senate debate ... on article 9(4) shows the preferred method to deal with the issue of the states' use of the worldwide unitary method was on a comprehensive legislative basis." In other words, the Senate and the executive — the two entities responsible for making treaties — have acknowledged that the treaty process is not the preferred way to resolve this issue. (U.S. Const., art. II, 2, cl. 2.)

In marked contrast to the factors relied upon here by the Board stand the factors relied upon by the court in *Wardair*. In *Wardair*, the 1944 Convention specified which state taxes on aviation fuel could not be imposed, thereby strongly implying that other state taxes on aviation fuel could be imposed. Moreover, the 1966 Resolution specifically addressed the concern of subnational taxation. It was in the context of these two foundational documents that the American government and foreign governments negotiated many of their bilateral aviation agreements. In other words, the aviation agreements were being negotiated with an awareness of the type of tax involved in *Wardair* and the agreements did not prohibit such a tax. In fact, the relevant agreement in *Wardair* — the 1974 U.S.-Canadian Agreement — was limited to national taxes, was signed by two federalist nations long after the 1944 Convention and the 1966 Resolution, and was performed in a manner indicating the tax involved in *Wardair* was permitted. These factors in *Wardair* made it "abundantly clear" that the federal government had "affirmatively decided to permit the States to impose these sales taxes on aviation fuel." (477 U.S. at p. 12, 106 S.Ct. at p. 2375.) The same cannot be said for the factors cited here by the Board.

Our conclusion that *Wardair* is inapplicable is buttressed by the fact that the *Container* court had before it all of the significant factors upon which the Board relies and nevertheless

engaged in a dormant foreign commerce clause analysis. (463 U.S. at pp. 196-197, 103 S.Ct. at pp. 2956-2957.) Obviously, the *Container* court did not think the Board's factors made it "abundantly clear" that the federal government had affirmatively acted to permit the states to apply the worldwide unitary method to domestic-parent groups with foreign subsidiaries. Accordingly, we proceed to a foreign dormant commerce clause analysis and apply the corresponding test created in *Japan Line* and refined in *Container*.

2. The Applicable Test and Standard of Review

Under the dormant foreign commerce clause test created in *Japan Line*, a state taxation method is unconstitutional if it either creates a "substantial risk of international multiple taxation" or "may impair federal uniformity in an area where federal uniformity is essential" and prevents "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" (441 U.S. at pp. 448, 451, 99 S.Ct. at pp. 1821-1823.) In refining *Japan Line*'s "one voice" standard, *Container* stated: "... we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '(a)bsent some explicit directive from Congress, ... that treatment of foreign income at the federal level mandates identical treatment by the States.' [Citations.] Thus, a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive [the second of these considerations being essentially a species of preemption analysis]." (463 U.S. at p. 194, 103 S.Ct. at p. 2955, emphasis in original.)

As for the standard of review, Colgate asserts we must use a two-step procedure. First, we are to determine whether substantial evidence supports the trial court's factual finding that California's use of the worldwide unitary method interferes

with American foreign policy. Secondly, we are to apply the constitutional "one voice" standard to that supported factual finding. Colgate's position is not without constitutional analogy — it is similar to the constitutional appellate inquiry conducted in Fourth Amendment cases. (See *People v. Leyba* (1981) 29 Cal.3d 591, 596-597, 174 Cal.Rptr. 867, 629 P.2d 961.) Nevertheless, the Board correctly sets forth the simpler standard of review we use here.

The foreign commerce clause issue in this case was submitted solely on exhibits that were not materially disputed by either of the parties. The issue, therefore, reduces to the applicability of the foreign commerce clause to uncontradicted facts. This presents a question of law and we are not bound by the trial court's findings. (*Western Contracting Corp. v. State Board of Equalization* (1968) 265 Cal.App.2d 568, 575, 71 Cal.Rptr. 472; *C.R. Fedrick, Inc. v. State Bd. of Equalization* (1988) 204 Cal.App.3d 252, 258, 251 Cal.Rptr. 305.) Accordingly, we independently analyze the foreign commerce clause issue presented here. With these general guidelines in mind, we apply the relevant constitutional tests.

A. The Enhanced Risk of Multiple Taxation

On this issue, there is no distinction between this case and *Container*. Having nothing distinctive to say, we simply reiterate *Container*'s conclusion that California's application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries is not unconstitutional on this ground.

B. Whether California's Application Of The Worldwide Unitary Method To Domestic-Parent Groups With Foreign Subsidiaries May Impair Federal Uniformity In An Area Where Federal Uniformity Is Essential And Prevents The Federal Government From Speaking With One Voice In Regulating Commercial Relations With Foreign Governments

In the context of the case before us, the "foreign policy implications" and the "clear federal directive" strands of *Container*'s "one voice" refinement become somewhat muddled. Essentially, the position of Colgate — and of the trial court below — is that after *Container* the federal executive branch acted to communicate clearly its longstanding policy that states are not to apply the worldwide unitary tax method to any multinational corporation — be it domestic-parent or foreign-parent — because such application interferes with the federal government's conduct of foreign policy and foreign affairs. For this position, Colgate and the trial court relied on (1) a 1985 statement issued by President Ronald Reagan, (2) a 1986 letter from Secretary of State George Shultz to California Governor George Deukmejian, (3) a 1986 letter from Treasury Secretary James Baker to Senator Bob Packwood, chairman of the Senate Finance Committee (an identical letter was sent by Secretary Baker to Representative Dan Rostenkowski, chairman of the House Ways and Means Committee), (4) an amicus trial brief from the United States filed in another case this court reviewed (*Barclays Bank v. Franchise Tax Bd.* 225 Cal.App.3d 1342, 275 Cal.Rptr. 626 (1990) (ptn. for review granted 2/28/91), and (5) statements by two attorneys from the United States Department of Justice that the views expressed in that amicus brief remained unchanged at the time of trial in this case.

Before we analyze the substance of this issue, we must address the Board's contention that the statements and letters noted above do not constitute evidence we can consider. We

reject the Board's contention for three reasons. First, statements and letters from executive branch officials have been recognized as evidence by both the United States Supreme Court and the California courts. (*Zschernig v. Miller* (1968) 389 U.S. 429, 437, fn. 7, 88 S.Ct. 664, 669, fn. 7, 19 L.Ed.2d 683; *Spindulys v. Los Angeles Olympic Organizing Com.* (1985) 175 Cal.App.3d 206, 210, fn. 3, 220 Cal.Rptr. 565.) Second, in *Container*, diplomatic letters and notes from foreign governments were admitted into the record. (463 U.S. at p. 203, fn. 4, 103 S.Ct. at p. 2960, fn. 4.) Finally, the Board concedes the authenticity of these statements and letters. Under these circumstances, we conclude the statements and letters constitute evidence we can consider.

To analyze this evidence adequately, however, some background is required. The distinction between a domestic-parent and a foreign-parent group was deemed significant by the *Container* court. That court explicitly reserved the issue of "the constitutionality of [the worldwide unitary method] with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." (463 U.S. at p. 189, fn. 26, 103 S.Ct. at p. 2953. fn. 26.) That court also carefully noted the tax there was imposed on a domestic-parent group, "not on a foreign entity as was the case in *Japan Line*;" and that "[a]lthough California 'counts' income arguably attributable to foreign corporations [i.e., foreign subsidiaries] in calculating the taxable income of that domestic corporation, the legal incidence of the tax falls on the domestic corporation." (*Id.* at p. 195, 103 S.Ct. at p. 2956.) Finally, *Container* recognized "that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests." (*Id.* at p. 195, fn. 32, 103 S.Ct. at p. 2956, fn. 32.)

In response to complaints about the *Container* decision raised by the domestic and the foreign business communities

and by foreign governments, President Reagan in 1983 asked then Treasury Secretary Donald Regan to establish and chair a Worldwide Unitary Taxation Working Group (Working Group). The Working Group was comprised of representatives of the federal government, the state governments, and the business community, and was to provide recommendations on the worldwide unitary issue. No foreign government representative was appointed.

At its final meeting in May 1984, the Working Group agreed on three principles to guide state taxation of multinational corporations: (1) "Water's edge" unitary combination for both domestic-parent and foreign-parent groups (i.e., essentially an allocation method with the United States as the relevant jurisdiction); (2) Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and (3) Competitive balance for domestic-parent groups, foreign-parent groups, and purely domestic businesses. In transmitting the Working Group's report to the President, Secretary Regan indicated he would recommend restrictive federal legislation if the states had not made substantial voluntary progress on the worldwide unitary issue by the end of July 1985.

It was against this backdrop that President Reagan issued the (November) 1985 statement involved here. In that statement, the President said in pertinent part: "Since early in this Administration, we have been working with the states, the business community, and foreign governments in an effort to resolve issues related to state use of the worldwide unitary method of taxation. At this time I believe it appropriate for the Federal Government to state its support for the concept of legislation that would: [¶] 1. Effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ('the water's edge requirement'); and [¶] 2. Address the question of equitable taxation of foreign source dividends. [¶] We hoped that by this time these prin-

ciples would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting [sic] Federal legislation to incorporate these principles into law and to work with the Congress for passage, and also, where appropriate, to enter into negotiations to amend double taxation agreements. ... [¶] Further, I am instructing the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach."

Our task is to analyze this statement as well as the other statements, letters, and briefs noted above from executive branch officials to determine if they either constitute an authoritative expression of the federal government that state application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries implicates foreign policy issues which must be left to the federal government or constitute a clear federal directive violated by California here. (*Container, supra*, 463 U.S. at p. 194, 103 S.Ct. at p. 2955.)[7] For the reasons set forth below, we conclude that California's application of the worldwide unitary tax method to Colgate does not offend the foreign commerce clause.

President Reagan issued his 1985 statement against the backdrop of the *Container* decision and the recommendations of the Working Group. In line with those recommendations, President Reagan stated the federal government's support for legislation that would effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States (the "water's edge" requirement). The

[7] We assume without deciding that the "clear federal directive" precept set forth in *Container* applies to directive from the federal executive branch. (*Container, supra*, 463 U.S. at pp. 194-197, 103 S.Ct. at pp. 2955-2957; see also Tribe, American Constitutional Law (2d ed. 1988) Federal Executive Power, §§ 4-4, 4-6, pp. 219-225, 230.)

President's statement did not distinguish between domestic-parent and foreign-parent multinationals. From this, it reasonably can be inferred that the executive branch — at least when President Reagan was at the helm — did not want states applying the worldwide unitary method to domestic-parent groups.

Nevertheless, when we examine the other parts of President Reagan's statement in the context of the foreign commerce clause issue presented here, this reasonable inference starts to erode.

Pursuant to the President's statement, the Attorney General was instructed "to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach." In the context of the case before us, this instruction is most troubling. This is because the executive branch has neither filed an amicus brief here nor indicated in any way its position on the issue presented in this case: California's application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries.

We can conceive of no more appropriate a case than this one for the executive branch to make its post-*Container* position clear. The factual context of this case is identical to *Container*. *Container* noted the absence of an executive branch amicus brief and noted that foreign policy nuances are much more the province of the executive branch and Congress than of the judiciary. (463 U.S. at pp. 195-196, 103 S.Ct. at pp. 2955-2956.) As one commentator on the *Container* decision has noted, "[g]iven the unusual attention paid to his absence, the Solicitor General's position in future appeals is certain to be a focus of attention." (WhiteNack, 20 Tax Notes (1983) 771, 780.) As we have seen, *Container* emphasized repeatedly the distinction between domestic-parent and foreign-parent corporations. And, like *Container*, this case arises from California's application of the worldwide unitary method, indisputably the

most important state applying the method. (Langbein, 23 Tax Notes, supra, at p. 626.)

Now, it might be argued, the federal Justice Department attorneys are busy people and they cannot be aware of all the relevant cases being litigated across the land. There are several problems with this argument, however. The number of relevant cases is relatively small given the small number of states that have employed the worldwide unitary method. (In fact, California apparently is the only state currently using the method; of course, it too has now adopted a "water's edge" election. (See fn. 4, *ante*.) As noted previously, no one would dispute that California is *the* pivotal state on this issue given the sheer size of its economy and its more comprehensive application of the method. (See Langbein, 23 Tax Notes, supra, at p. 626; Comment, *California's Corporate Franchise Tax: Taxation of Foreign Source Income?* (1980) 20 Santa Clara L.Rev. 123, 134.) And, of course, the "appropriate" nature of the present case cannot be denied. But most significantly, the United States Department of Justice was twice notified about this case by letters from Colgate's counsel. Two high-ranking Justice Department attorneys responded to those letters by stating that the position taken by the United States in *Barclays Bank of California v. Franchise Tax Board* — then pending in the Superior Court of California for Sacramento County (Nos. 325061, 325059) — and the position taken in *Alcan Aluminum v. Franchise Tax Board* and *Imperial Chemical Industries PLC v. Franchise Tax Board* — then pending in the United States District Court for the Northern District of Illinois (Nos. 84-C-6932, 84-C-8906, respectively) — remained the position of the United States.

These two letters from the Justice Department attorneys are the same two letters Colgate relies upon here to argue that the federal executive has indeed made its views known in this case and that an executive amicus brief or other statement of position is unnecessary. The problem for Colgate is that the

Barclays, Alcan and Imperial Chemical cases all involved the application of the worldwide unitary method to *foreign*-parent groups. (See *Franchise Tax Bd. v. Alcan* (1990) 493 U.S. 331, ____, 110 S.Ct. 661, 664, 107 L.Ed.2d 696, 702.) According to the Justice Department letters, the three cases "involved the appropriateness of taxation *of the plaintiffs* [i.e., foreign-parent multinationals] on a worldwide unitary basis under California law prior to the September, 1986, amendment thereto [*i.e.*, the "water's edge" election]. [¶] In those cases the United States filed briefs amicus curiae wherein it stated its position on the *above-stated issue*." (Emphasis added.)

A matter we can judicially notice supports our conclusion. We filed a decision in the Barclays case on November 30, 1990. (225 Cal.App.3d 1342, 275 Cal.Rptr. 626; ptn. for review granted 2/28/91.) In that action, the United States filed an amicus brief with this court. (Evid. Code, 452, subd. (d), 459, subd. (a).)[8] That amicus brief was authored under the supervision of one of the Justice Department attorneys who responded by correspondence to Colgate's counsel here. That brief stated in part: "It is the position of the United States Government, as reflected in the letter of ... Secretary of State [Shultz] to ... Governor [Deukmejian] [the same letter Colgate relies upon here], that the unitary tax is at odds with the 'arm's length' accounting method which is the international rule and standard, and that adherence to the 'arm's length' method of taxing corporations with foreign parents is essential to avoid adverse consequences for the foreign relations of the United States. (Letter.) ... *Container Corp.* involved the application of California's tax to a domestically controlled group of corporations and it was that issue on which the Federal Executive expressed no view. The Supreme Court in *Container Corp.*, as

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[8] Compliance with Evidence Code section 455, subdivision (a) is unnecessary (Evid. Code, § 459, subd. (c)) because Colgate has relied on the United States' amicus trial brief in the Barclays case and has introduced and had admitted various parts of the Barclays record as part of the record here.

stated before, expressly reserved judgment on the issue *sub judice* in this case, and with respect to this issue the Federal Executive is filing a brief *amicus curiae* and is expressing its policy and position. In the instant case therefore, this Court should have no difficulty in determining the Federal Executive's views. The statements of the Secretary of State (Letter) and the President of the United States, (Statement) [the same statements Colgate relies upon here] demonstrate that the Federal Government has a clearly articulated policy in favor of 'arm's length' accounting in the conduct of foreign affairs, and that California's worldwide combined unitary business concept method is in conflict with the internationally accepted standard and policies, and custom, and this in turn has caused serious disputes and difficulties for the United States in the conduct of foreign affairs. Finally, precisely because of these foreign policy considerations and because of their gravity, the Department of Justice, at the direction of the President, is filing this *amicus curiae* brief." (Barclays C003388 U.S. Amicus App. Brief, pp. 31, 33-35.) As noted, we do not have any statement from the executive in the present litigation.

It also might be argued that the executive branch need not continually have to set forth its position. The President has issued an authoritative statement; the matter is settled; how many more times does something have to be said? Of course, the problem with this argument is that in the President's statement, the President instructs the Attorney General to ensure that the United States' interests are represented in appropriate cases consistent with the statement. The President's statement arguably covers domestic-parent groups and the executive branch was notified about this significant and appropriate case. Nevertheless, the executive branch here, as in *Container*, has chosen to remain silent.

In sum, the executive branch was twice explicitly notified about this case. This case could not have provided a more appropriate context for the executive branch to express its views

regarding the application of the worldwide unitary method to domestic-parent groups with foreign subsidiaries. The President's statement instructed the Attorney General to ensure that the United States' interests were represented in appropriate cases. Nevertheless, the executive branch has done nothing here to make its position known. Under these circumstances, we cannot say that President Reagan's statement either constitutes an authoritative expression of the federal government that application of the worldwide unitary method to domestic-parent groups with foreign subsidiaries implicates foreign policy issues which must be left to the federal government or constitutes a clear federal directive which California has violated here.

We now examine Secretary of State Shultz's 1986 letter to Governor Deukmejian. The purpose of this letter was to note that the Reagan Administration had proposed federal legislation prohibiting worldwide unitary taxation, but that similar action at the state level would be welcomed. Apparently this legislation would have prohibited the application of the worldwide unitary method to all multinational corporations, be they domestic-parent or foreign-parent. Nevertheless, Secretary Shultz's 1986 letter provides no stronger support for Colgate's *foreign commerce clause* position than did President Reagan's 1985 statement.

In that letter, Secretary Shultz states that "[t]he longstanding policy of the federal government has been to follow the separate accounting method. The United States has advocated and adopted the position that the 'arm's-length' adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed. This view is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties.

There is an important passage in *Container*, however, which calls into question the Secretary's statement in the domestic-parent context. As noted in *Container*: "[A]lthough the United States is a party to a great number of tax treaties that require the Federal Government to adopt some form of arm's-length analysis in taxing the domestic income of multinational enterprises, that requirement is generally waived with respect to the taxes imposed by each of the contracting nations on its own domestic corporations. This fact, if nothing else, confirms our view that such taxation is in reality of local rather than international concern." (463 U.S. at p. 196, 103 S.Ct. at 2956.) Thus, the longstanding policy and position expressed by Secretary Shultz — embodied in the Internal Revenue Code and a central feature in American bilateral tax treaties — apparently does not apply to the taxation of domestic-parent groups by their home countries but applies only to the taxation of foreign-parent groups.

The Secretary of State's letter further specifies that "[y]our state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states"; that continued state use of the worldwide unitary method "will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation"; and finally that "[t]he worldwide unitary issue has seriously complicated our economic relations with many of our closest allies."

In making these observations, however, Secretary Shultz relies primarily on factors illustrating that the foreign commerce problem is limited to foreign-parent groups and does not encompass their domestic-parent counterparts. For example, the Secretary notes the worldwide unitary method can impede foreign entry into the United States market. He discusses the administrative burdens of compliance, particularly

for foreign-controlled entities. He cites to the diplomatic notes received from many countries complaining about state use of the worldwide unitary tax method. Although the specific contents of these notes are not set forth, similar protests in *Container* were discussed in the exclusive context of the foreign-parent group. (463 U.S. at pp. 202-203, fn. 4, 103 S.Ct. at pp. 2959-2960, fn. 4.) Finally, the Secretary notes that British "anti-unitary retaliatory legislation" has been adopted denying *U.S.-parent* corporations operating in worldwide unitary states a very valuable benefit under the U.S.-U.K. Tax Treaty. From all of this, it is difficult to discern genuine executive branch concern — arising from issues germane to the foreign commerce clause — regarding state application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries.

That brings us to Treasury Secretary James Baker's 1986 letter to Senator Bob Packwood, chairman of the Senate Finance Committee. (An identical letter was sent by Secretary Baker to Representative Dan Rostenkowski, chairman of the House Ways and Means Committee.) This letter was sent "to describe the serious concerns that have led the [Reagan] Administration to propose and support [the] legislation" (alluded to in Secretary Shultz's letter to Governor Deukmejian).[9]

Those "serious concerns", however, are largely the same concerns noted in Secretary Shultz's letter: the longstanding policy of separate accounting embodied in the Internal Revenue Code and a central feature in the bilateral tax treaties; the diplomatic notes from countries around the globe complaining about state use of the worldwide unitary method; the British anti-unitary retaliatory legislation aimed at U.S.-parent multinational corporations; the administrative burdens of

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[9] Congress never enacted this proposed legislation.

compliance, particularly for foreign-owned companies; and the barrier to foreign entry into the United States market. As we have seen, these matters illustrate that the foreign commerce problem involves foreign-parent groups rather than their domestic-parent counterparts. Consequently, these matters do not support Colgate's argument that California's application of the worldwide unitary method to domestic-parent groups with foreign subsidiaries is unconstitutional under the foreign commerce clause because it interferes with the conduct of American foreign policy.

This view is bolstered by Senator Pete Wilson's comments in the Congressional Record made during his introduction of the subject legislation in the Senate. Senator Wilson stated: "While the principal foreign commerce issues raised by State worldwide unitary taxation would be resolved if States were to agree that they would not impose worldwide unitary tax on foreign controlled entities, such [a] limited resolution would cause other serious problems. If a 'foreign only' solution were adopted, domestically controlled businesses would thereby be disadvantaged."

Secretary Baker's letter to Senator Packwood does note the Working Group's principle of "water's edge" (allocation methods restricted to United States boundaries) for both domestic-parent and foreign-parent companies in line with the Working Group's principle of competitive balance for all companies, whether domestic or foreign. The problem for Colgate in this appeal is that domestic-parent groups are included in the proposed restrictive legislation on "competitive balance" grounds rather than on the foreign commerce clause grounds set forth in *Japan Line* and *Container*. "Competitive balance" for domestic corporations is not an issue under the dormant foreign commerce clause "one voice" test created in *Japan Line* and refined in *Container*. (*Japan Line, supra*, 441 U.S. at pp. 456-457; see *Container, supra*, 463 U.S. at pp. 188-189, 195, fns. 26, 103 S.Ct. at pp. 2952-2953, 2956, fns. 26.)[10]

Under the "foreign policy implications" precept of *Container*'s "one voice" refinement, we must determine whether California's application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries "implicates foreign policy issues which must be left to the Federal Government." (463 U.S. at p. 194, 103 S.Ct. at p. 2955.) As we have seen, the President's statement, the two Secretary letters, and the two letters from the Justice Department attorneys show that the foreign commerce problem is essentially limited to foreign-parent groups and does not materially involve their domestic-parent counterparts. "Competitive balance" for domestic corporations is not part of the "foreign policy implications" issue. Therefore, the statement and letters from the executive branch officials do not constitute, either individually or collectively, an authoritative expression of the federal government that state application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries implicates foreign policy issues which must be left to the federal government.

Of course, our analysis is not confined merely to foreign policy implications. We must also consider whether the President's statement, the Secretaries' letters, and the Justice Department attorneys' letters constitute, individually or cumulatively, a clear federal directive violated by California here. The "clear federal directive" envisioned in *Container* does not exist in a vacuum, but is part of the foreign commerce

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[10] In arguing for mandatory equal tax treatment for domestic-parent and foreign-parent groups, Colgate relies on *Star-Kist Foods, Inc. v. County of Los Angeles*, supra, 42 Cal.3d 1, 227 Cal.Rptr. 391, 719 P.2d 987. *Star-Kist*, however, recognizes *Japan Line*'s sanction of inequality if necessary to preserve the values embodied in the dormant foreign commerce clause. (42 Cal.3d at pp. 12-14; see fn. 13, *post*.)

clause "one voice" standard enunciated in that case. (463 U.S. at p. 194, 103 S.Ct. at p. 2955.) Arguably, then, the directive is in some way linked to issues of foreign commerce or foreign affairs. In the statement and letters at issue here, however, the state application of the worldwide unitary tax method to domestic-parent groups is not linked to issues of foreign commerce or foreign affairs. To the contrary, the statement and letters relegate those issues to the foreign-parent context. Moreover, the statement and letters, as analyzed above, are ambiguous regarding the domestic-parent context. Such ambiguity is inconsistent with a clear directive.

Nevertheless, one could also argue persuasively that *Container*'s "clear federal directive" precept need not be linked to foreign policy. This is because a genuine and authoritative clear federal directive must always be acknowledged, regardless of whether it was promulgated in the context of foreign policy or domestic policy. (U.S. Const., art. VI, cl. 2; Tribe, Amer. Const.Law, *supra*, Limits on State and Local Power, pp. 479-511.) But conceding this point does not help Colgate.

In *Container*, the court did not find any "clear federal directive" from Congress. (463 U.S. at pp. 196-197, 103 S.Ct. at pp. 2956-2957.) That situation has not changed since *Container*. (See fn. 9, *ante*.) We therefore are left with the executive branch as the source of the directive, assuming that branch can be the source. (See fn. 7, *ante*.) Our analysis has shown that this case, like *Container*, presents an essentially domestic issue. However, in the domestic policy arena — in contrast to the foreign policy sphere — the executive's powers and its ability to formulate policy are much more limited. (Tribe, Amer. Const.Law, supra, Federal Executive Power, §§ 4-2, 4-4, pp. 210-213, 219-225.) If the executive branch indeed has a clear federal directive on the domestic issue involved here, why has that branch not presented this court with an amicus brief or other affirmation of that directive? As we have seen, this is especially troubling given that the executive branch was twice

notified about this case, given that this case presents an extremely appropriate context for the executive to make its post-*Container* views known (be they domestic-oriented or foreign-oriented), and given that President Reagan's 1985 statement instructed the Attorney General to ensure that federal interests were represented in appropriate cases. The executive's failure here to assert any directive evidences either the lack of such a directive or the ambiguity of one, if one exists. When these circumstances are aligned against the fundamental concept of state sovereignty and the broad power of a state to tax (see *Hines v. Davidowitz* (1940) 312 U.S. 52, 68, 61 S.Ct. 399, 404, 85 L.Ed. 581, 587-588), the argument for a clear federal directive in this case evaporates.

Finally, in addition to its principal evidence analyzed above, Colgate relies on a federal district court case in Alaska filed in 1987 by the United States against the state of Alaska. Colgate alleges this case demonstrates the federal government's commitment to eradicate state use of the worldwide unitary method. Again, however, the Alaska suit involved the application of the worldwide unitary tax method to a *foreign*-parent group and it was on that basis the United States sought a judgment declaring the method unconstitutional. Rather than support Colgate's foreign commerce clause argument, the Alaska case undermines it.[11]

Because we conclude that the evidence relied upon by Colgate does not show any foreign policy implications or clear federal directives which alter the *Container* "one voice" analysis, that analysis remains valid in the context of this case. A few general observations buttress our position.

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[11] The Board asks that we take judicial notice of a stipulation of dismissal in the Alaska action, based on a settlement. We do so. (Evid. Code, §§ 452, 459.)

In marked contrast to the record presented to this court in the Barclays case (*Barclays Bank v. Franchise Tax Bd.*, 225 Cal.App.3d 1342, 275 Cal.Rptr. 626 (ptn. for review granted 2/28/91)), the record presented here contains no statements, protests, or amici briefs from foreign governments or representatives of foreign interests. (Evid.Code, §§ 452, subd. (d), 459, subd. (a); see fn. 8., *ante*.) This is not really surprising, however. The difference between applying the worldwide unitary tax method to a domestic-parent group and applying it to a foreign-parent group is a distinction of significance in the context of foreign commercial relations and the "custom of nations." (See *Japan Line, supra*, 441 U.S. at p. 454, 99 S.Ct. at p. 1824.) This is because the worldwide nature of the tax method at issue falls ultimately on the parent corporation. It is the parent's worldwide income that is apportioned. It is the parent's worldwide operations that are scrutinized. It is the parent upon whom the worldwide administrative burden of compliance falls. By definition, the worldwide unitary method seeks the ultimate source of corporate responsibility and that source is the global parent. Unlike the domestic parent, the foreign parent is likely versed only in the separate accounting tradition, is likely unfamiliar with the concepts of federalism and genuine subnational sovereignty, and is often intimidated by the complexities of our multi-level system of government. In this context, foreign resentment of the worldwide unitary method is understandable. In contrast, the foreign subsidiary of a domestic-parent is merely a cog in the unitary wheel; the parent is the hub. Put simply, the foreign subsidiary of a domestic-parent is akin to a child who is not saddled with parental responsibilities.

Furthermore, although we are increasingly entering a global economy where national boundaries are less significant, there is still a nationalistic dignity associated with the "home base" of a multinational corporation. There is nothing unnatural about the assertion of this dignity. (See *Japan Line, supra*, 441 U.S. at p. 456, 99 S.Ct. at p. 1826.)

Presented in this case is the very line of federalism. On one side of the line is the federal government's rightful power to conduct foreign affairs without interference from the states. (See *Japan Line, supra*, 441 U.S. at pp. 448-457, 99 S.Ct. at pp. 1821-1826.) On the other side is the states' rightful power to tax as a separate sovereign. (*Hines v. Davidowitz*, supra, 312 U.S. at p. 68, 61 S.Ct. at p. 404.) In this fundamental clash of political power, we look to the two political branches of our national government to specify if a state's activity is jeopardizing foreign policy positions that are inherently national in character. (*Container, supra*, 463 U.S. at pp. 194-196, 103 S.Ct. at pp. 2955-2956.) Neither branch has specified foreign policy implications here. And the length of our "clear federal directive" discussion illustrates perhaps better than the discussion itself the lack of such a directive on the issue presented in this case. Nor can the federal government, as we have seen, plead ignorance about this case or claim the case presents an inappropriate context in which to state its views. In fact, here the federal executive did not see fit to follow its own pronouncement to make sure federal interests were represented in appropriate cases. In this posture, we cannot say that California's application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries is unconstitutional under the foreign commerce clause because it either impermissibly interferes with the conduct of foreign policy or violates a clear federal directive. In this light, *Container*'s conclusion remains valid that such "taxation is in reality of local rather than international concern." (463 U.S. at p. 196, 103 S.Ct. at p. 2956.)

Based on the uncontradicted evidence presented here, we hold that California's application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries is

not unconstitutional under the foreign commerce clause of the Federal Constitution.[12]

3. Did California Unlawfully "Distort" the Amount of Colgate's Income Apportioned to California?

Although Colgate did not file a cross-appeal, it argues the trial court erroneously determined that California's application of the worldwide unitary tax method to Colgate did not unlawfully "distort" the amount of Colgate's income apportioned to California. We denied the Board's motion to strike this argument from Colgate's respondent's brief. Accordingly, we consider the issue.

Colgate's argument is premised on what *Container* described as the "external consistency" requirement of fairness in an apportionment formula. Under that requirement, the application of a tax apportionment formula, such as California's worldwide unitary tax method, must be fair to pass constitutional scrutiny under both the due process and the commerce clauses; stated another way, the formula must actually reflect a reasonable sense of how income is generated. (*Container, supra*, 463 U.S. at pp. 169-170, 103 S.Ct. at pp. 2942-2943; *Trinova Corp. v. Michigan Dept. of Treasury* (1991) 498 U.S. ___, 111 S.Ct. 818, 112 L.Ed.2d 884.) Under this constitutional edict, an appor-

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[12] On constitutional grounds involving equal protection and the commerce clause, Colgate also argues that foreign-parent groups and their domestic-parent counterparts must be treated identically for tax purposes. We are not aware of any final decision holding that state application of the worldwide unitary tax method to foreign-parent groups is unconstitutional under the foreign commerce clause. Until such decision, this issue of equality is premature. There is a well-settled principle that courts do not consider constitutional issues that are not ripe for determination. (*Regional Rail Reorganization Act Cases* (1974) 419 U.S. 102, 138, 95 S.Ct. 335, 356, 42 L.Ed.2d 320, 350.) We adhere to that principle in this case and do not express any views on this issue. (See fn. 10, *ante*.) We do note that this issue was not litigated below in any meaningful fashion, was not part of the trial court's decision, and consequently has not been briefed adequately here.

tionment formula will be invalidated if the taxpayer can prove by clear and cogent evidence that the income attributed to the state is "'out of all appropriate proportion to the business transacted by the [taxpayer] in that State'" or has "'led to a grossly distorted result.'" (*Container*, supra, 463 U.S. at pp. 170, 181, 103 S.Ct. at pp. 2942, 2948; *Trinova*, supra, 498 U.S. at p. ___, 111 S.Ct. at p. 832-833, 112 L.Ed.2d at pp. 908-909.)

In addition to the constitutional "external consistency" requirement, there is a statute in California on the subject. Revenue and Taxation Code section 25137 provides: "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: [¶] (a) Separate accounting; [¶] (b) The exclusion of any one or more of the factors; [¶] (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or [¶] (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Colgate argues that California's worldwide unitary tax method apportioned 70 percent more income to California in comparison to separate accounting and that such apportionment contravenes both the constitutional and the statutory distortion principles. We disagree.

As noted by one commentator in reviewing *Container*'s discussion of the constitutional distortion principle of "external consistency," the taxpayer's burden of proof on this issue is "steep if not insurmountable." (23 Columbia Journal at p. 457.) This is an accurate comment. In *Container*, the court noted that the three-factor formula used by California has not only "met our approval" but has become "something of a

benchmark against which other apportionment formulas are judged." (463 U.S. at p. 170, 103 S.Ct. at p. 2942.)

Container also noted the distortion figures in that case were based essentially on separate accounting methods that failed to account for the flow of value between the parts of the unitary business. (*Id.* at pp. 181-184, 103 S.Ct. at pp. 2948-2950.) The same can be said here.

Colgate argues the distortion arises here because Colgate's foreign subsidiaries are substantially more profitable than its California operations. That is, the foreign subsidiaries' lower property, payroll, and sale figures for the same level of productivity result in a distorted apportionment to California under the three-factor formula. In *Container*, the taxpayer made the same argument. The court in *Container* rejected this argument, stating: "The problem with this argument is obvious: the profit figures relied on by [the taxpayer] are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." (463 U.S. at p. 181, 103 S.Ct. at p. 2948.)

Apparently, there is only one United States Supreme Court decision that has invalidated a state tax apportionment formula applied to a corporate income tax or a franchise tax of a manufacturing or mercantile company like Colgate. (23 Columbia Journal at pp. 450-451; see also *Container, supra*, 463 U.S. at pp. 182-184, 103 S.Ct. at pp. 2949-2950.) That decision is from 1931 and is entitled *Hans Rees' Sons Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 51 S.Ct. 385, 75 L.Ed. 879 (1931). In that case, a one-factor unitary tax method was applied to a domestic company. Although the company's income in *Hans Rees'* was derived from a variety of far-flung activities — including buying, selling and manufacturing — North Carolina's statutory formula allocated the entire wholesale profit to North Carolina, where the manufacturing occurred. This allocation resulted in 250 percent more income attributed

to the state. (283 U.S. at pp. 126-128, 51 S.Ct. at pp. 386-387; see 23 Columbia Journal at p. 450; *Container, supra*, 463 U.S. at pp. 183-184, 103 S.Ct. at pp. 2949-2950.)

Colgate's 70 percent figure — which does not account for the flow of value between the parts of Colgate's unitary business — is not comparable to the 250 percent tally in *Hans Rees'*. Colgate has not met the steep burden imposed by the constitutional distortion principle of "external consistency."[13]

Colgate realizes this and pins its hopes on Revenue and Taxation Code section 25137. Colgate faces an uphill battle here as well. Under section 25137 and California case law, the Franchise Tax Board is given discretion to select the factors to be used in a tax formula. (*McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506, 512, 72 Cal.Rptr. 465, 446 P.2d 313.) Where a taxpayer petitions for an alternative formula under section 25137, the taxpayer bears the burden of establishing by clear and convincing evidence that the formula used by the Franchise Tax Board reaches an unreasonable result in his or her case. (*Ibid.*; Rev. & Tax.Code, 25137; *Communications Satellite Corp. v. Franchise Tax Bd.* (1984) 156 Cal.App.3d 726, 746-749, 203 Cal.Rptr. 779; see, e.g., *Firestone Tire & Rubber Co. v. County of Monterey* (1990) 223 Cal.App.3d 382, 387-388, 272 Cal.Rptr. 745.)

Colgate argues that the trial court used the constitutional "out of all proportion" test to dismiss Colgate's statutory assertion under section 25137. Additionally, Colgate argues that testimony from the Board's counsel for multi-state tax affairs establishes that the Board unlawfully fails to consider separate

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[13] In a recent decision, the United States Supreme Court relied on *Container's* flow of value concept to uphold the application of the three-factor formula involved here to a value added tax on a unitary business. (*Trinova*, supra, 498 U.S. ____, 111 S.Ct. 818, 112 L.Ed.2d 884.)

accounting as an alternative for unitary companies under section 25137. Neither of these arguments has merit.

As noted by the Board, the trial court did not apply the constitutional "out of all proportion" test to the statutory issue. In reviewing the Board's denial of Colgate's section 25137 petition, the trial court cited *Container*'s "flow of value" concept and upheld the Board's determination that Colgate had not demonstrated by clear and convincing evidence that California's apportionment formula unfairly represented the extent of Colgate's business activity in California. (*Container, supra,* 463 U.S. at pp. 181-184, 103 S.Ct. at pp. 2948-2950.) This constituted a correct application of the statutory standard set forth in section 25137. (*McDonnell Douglas Corp. v. Franchise Tax Bd.*, supra, 69 Cal.2d at p. 512, 72 Cal.Rptr. 465, 446 P.2d 313; see *Amoco Production Company v. Arnold* (1974) 213 Kan. 636, 518 P.2d 453, 463-465.)

Citing *Hunt-Wesson Foods, Inc. v. County of Alameda* (1974) 41 Cal.App.3d 163, 176, 116 Cal.Rptr. 160, Colgate contends the right to recover taxes paid under protest is a fundamental vested right; therefore, the trial court was obligated to exercise its independent judgment on the section 25137 evidence. We disagree with Colgate for two reasons. First, the *Hunt-Wesson* court did not hold that the right to recover taxes paid under protest is a fundamental vested right. That court said the argument could be made. (41 Cal.App.3d at p. 176, 116 Cal.Rptr. 160.) Second, and more importantly, the precise issue involved here concerns the application of a particular tax method that is within the discretion of the Franchise Tax Board under statutory directive. (*McDonnell Douglas Corp. v. Franchise Tax Bd.*, supra, 69 Cal.2d at p. 512, 72 Cal.Rptr. 465, 446 P.2d 313; Rev. & Tax.Code, §§ 25120-25139; Cal.Code Regs., tit. 18, § 25137-6; see *Amoco Production Company v. Arnold*, supra, 518 P.2d at pp. 463-465; see, e.g., *Firestone Tire & Rubber Co. v. County of Monterey*, supra, 223 Cal.App.3d at pp. 387-388, 272 Cal.Rptr. 745.) Colgate can hardly ascribe an individually "vested" status to this process. (See *Hunt-Wesson, supra,* 41 Cal.App.3d at p. 174, 116 Cal.Rptr. 160.) As noted, *McDonnell Douglas* is the relevant decision on this limited issue. (69 Cal.2d at p. 512, 72 Cal.Rptr. 465, 446 P.2d 313.)

Our resolution of the statutory distortion issue renders irrelevant Colgate's argument that the Board unlawfully fails to consider separate accounting as an alternative for unitary companies under section 25137. Colgate has not shown that California's apportionment formula unfairly represented the extent of Colgate's business activity in California. The alternatives set forth in section 25137 are invoked only if the taxpayer makes that showing. Consequently, we do not address this argument.

4. The Sanctions and Costs Issues

The Board claims the trial court abused its discretion in denying the Board's motion for sanctions against Colgate. In that motion, the Board argued that Colgate unduly delayed in producing certain documents evidencing the unitary nature of Colgate's operations.

This matter arose when Colgate, during the first two days of trial, belatedly produced to the Board's counsel five boxes of documents pursuant to the Board's requests for production of documents and a court order based on those requests. Included in this belated production were documents relevant to the operation of Colgate's Danish subsidiary and therefore relevant to the issue of whether Colgate's subsidiaries operated in a unitary fashion with the domestic parent corporation. This production occurred in mid-July 1988. It was not until mid-February 1989, however, that the Board moved for sanctions on this matter; this was after the trial was over and after the Board had won on the unitary issue. On these facts, the trial court declined to award sanctions because the motion was untimely and failed to evidence prejudice against the Board.

The trial court has broad discretion in imposing discovery sanctions, subject to reversal only for arbitrary, capricious or whimsical action. (See *Sauer v. Superior Court* (1987) 195 Cal.App.3d 213, 228, 240 Cal.Rptr. 489; *Kahn v. Kahn* (1977) 68 Cal.App.3d 372, 380-381, 137 Cal.Rptr. 332 [although these cases were not decided under the current discovery statutes, the general principle of review they enunciate remains valid. (*See* former Code Civ.Proc. § 2034.)].) Code of Civil Procedure section 2023, subdivision (b)(1), upon which the Board relies, does not alter this well-settled principle and the Board concedes as much. That section and subdivision provides in pertinent part that: "[i]f a monetary sanction is authorized by any provision of this article, the court shall impose that sanction unless it finds that the one subject to the sanction acted with substantial justification or that other circumstances make the imposition of the sanction unjust."

The Board argues that the trial court's finding of no prejudice conveys the message that it is acceptable to abuse discovery and conceal evidence, so long as the party seeking discovery cannot prove how those actions prejudiced its case. Of course, prejudice is difficult to prove in the face of victory. The Board's real concern is that such discovery abuse will go unpunished. The Board can rest assured that the trial court possesses an array of weapons to counter parties abusing the discovery process. These weapons include a "Monetary sanction," an "Issue sanction," an "Evidence sanction," a "Terminating Sanction," and a "Contempt Sanction." (Code Civ. Proc., § 2023, subd. (b)(1)(2)(3)(4)(5).) The problem for the Board here is that a timely motion for sanctions is required to make these sanctions effective. The Board made its motion after the trial was over and after it had won on the issue for which it sought sanctions. And the Board cannot claim it did not know about the discovery abuse until it made its motion in February 1989. The Board admits it uncovered the abuse in July 1988 during the first days of trial.

The Board argues it was prejudiced because it could have moved for summary judgment on the unitary issue had the documents been timely produced, and the trial could have been shortened if not eliminated. We doubt seriously that operational documents concerning one of Colgate's 75 foreign subsidiaries were the only evidence standing in the way of a summary judgment motion on the unitary issue. In any event, the nature of the unitary issue is essentially factual and particular to the corporate enterprise being examined. For that reason, the issue would not usually be amenable to summary adjudication resolution.[14] We also doubt that Colgate's timely production could have eliminated or significantly shortened the trial. The testimony part of the trial also encompassed the distortion issues, and the heart of the lawsuit concerned the foreign commerce clause issue.

The trial court did not abuse its discretion in denying the Board's motion for discovery sanctions.

Our partial reversal of the judgment renders moot the issue of costs awarded below to Colgate. Under our decision, Colgate is no longer the prevailing party.

DISPOSITION

The judgment on the foreign commerce clause issue is reversed. The judgment on the constitutional and statutory distortion issues and on the matter of sanctions is affirmed. The Board is awarded its costs on appeal.

PUGLIA, P.J., and CARR, J., concur.

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[14] We note that Code of Civil Procedure section 437c was amended in 1990 to eliminate motions for summary adjudication of *issue(s)*.

APPENDIX F

COLGATE-PALMOLIVE COMPANY
Plaintiff,

v.

FRANCHISE TAX BOARD,
Defendant.

No. 319715.

Superior Court of the State of California.
for the County of Sacramento

Apr. 19, 1989.

BACKGROUND

During the years 1970-1973, plaintiff, a Delaware Corporation with New York headquarters, maintained a sales organization, a warehouse and a manufacturing plant for its products in California. In addition to its other U.S. activities Plaintiff owned a controlling interest in 75 foreign subsidiaries.[1] Therein lies the genesis of this controversy. In assessing the California franchise tax during those years, California used what is known as the world-wide unitary method of accounting. Plaintiff contends (1) that it was not a worldwide unitary organization; (2) that the apportionment of the income of Colgate and its foreign subsidiaries so distorted the business activity of Colgate in California that an alternative method should have been used; and (3) that the Board's unitary method was an impermissible interference with the federal government's power to conduct foreign affairs. It paid its taxes under protest, followed proper administrative procedures, and this suit ensued.

[1] The development of plaintiff's overseas empire is of some interest. It started before World War I and the majority of the more successful of the subsidiaries date back to a period before World War II. Those subsidiaries now account for a lion's share of plaintiff's income and hire over 16,000 people as against its 6,000 domestic employees.

The general practice has been to approach a local soap maker and with his local facilities and local knowledge develop a subsidiary. The subsidiaries are almost entirely manned by local personnel. However, the general manager is always an employee of plaintiff. The subsidiaries operate under the general control of the foreign division of the parent company but

Footnote continued...

I.

WERE PLAINTIFF'S FOREIGN SUBSIDIARIES PART OF A UNITARY BUSINESS?

Yes.

As will be developed later, plaintiff contends that the so-called world-wide unitary method of taxation accounting by defendant is unconstitutional. That issue will be discussed in a subsequent part of this decision. However, for a discussion of the present argument I will assume its validity and address plaintiff's contention that it is not a unitary enterprise. (I will use the word "plaintiff" loosely, usually meaning the mother company, not the foreign subsidiaries but may slip from time to time, leaving it to the good sense of the reader to make the proper application.)

There is certainly no "bright line" as to just what a unitary method of doing business is. Sometimes, as one reads the

Footnote continued from previous page.
are given a great deal of local independence in production, marketing and advertising, because experience has shown that this is the most efficient method of operating a foreign subsidiary.

cases, it seems that the distinction is in the eye of the beholder. For example, *Container* (*Container Corporation of America vs. Franchise Tax Board*, 436 U.S. 159 and *Woolworth* (*F. W. Woolworth Co. vs. Taxation and Revenue Dept.*, 458 U.S. 354) are not the easiest cases to reconcile. Nevertheless, in broad terms it can be said that for a world-wide unitary relationship to exist there must be a "significant functional integration", i.e. "a centralization of management and economies of scale" that contribute to the income of the subsidiaries. (*Mobil Oil Corp. v. Vermont* 445 U.S. 425.) All the activities carried on by the separate entities must be part of a single unitary business. The most recent U.S. Supreme Court effort to define the concept is to be found in *Container*:

> "... The functional meaning of this requirement (unitary business) is that there be some sharing or exchange of values not capable of precise identification or measurement..." (*Supra*, p. 166.)

and:

> "The prerequisite to a constitionally acceptable finding of a unitary business is a "flow of value, not a flow of goods." (*Supra*, p. 178.)

Considering this rather broad terminology, it is probably not too surprising that courts have come to some rather inconsistent results in applying these definitions to particular sets of facts.

The California Supreme Court has added its contribution to this effort to define a unitary business by recognizing *two* tests of unity. The first is the so-called "three unities test", i.e. that a unitary business is established by the presence of the unities of ownership, operation and use (*Butler Bros v. McColgan* 17 Cal.2d 664), and the "contribution or dependency test" of *Edison California Stores vs. McGolgan* 30 Cal.2d 472, under which a business is unitary if operations within California are dependant on or contribute to the operation of the business outside the state.

Accepting these rather broad standards, plaintiff contends it is not unitary, that the subsidiaries are viertually [sic] autonomous and that the relationship between it and its subsidiaries was no more than could be expected by the parent company and a wholly-owned subsidiary. Needless to say, defendant contends that the activities of plaintiff and its subsidiaries constitute a unitary business. I find that they do.

Plaintiff's efforts to picture its overseas empire as consisting of a group of sturdy little independent nations held together by a series of loose treaties crumble under the impact of the evidence presented in this case, particularly the evidence of Mr. Foster, the one-time C.E.O. of the organization, plus the storm of strong documentary evidence produced.

While it is certainly arguable and perhaps dispositive (if a reviewing court should so decide) that plaintiff's failure to raise this issue before the Board precludes its present presentation, I chose to reach the merits of the issue. In substance, defendant presented more than substantial evidence of control, exchange of knowledge and the substantial "flow of value" between Colgate and the foreign subsidiaries and among the foreign subsidiaries themselves. *Container* virtually compels this conclusion.

A.

Contrary to plaintiff's contention, the test is not whether the foreign subsidiaries were unitary with plaintiff's operations in California during the years in question. Rather, the test is whether California's activities were part of the overall unitary business. (*Honolulu Oil Corp. vs. Franchise Tax Board*, 60 Cal.2d 417.) (Plaintiff has conceded that its United States operations are unitary.) Nevertheless, irrelevant though the evidence may have been, there *was* evidence that the foreign subsidiaries received some material from California, that personnel from foreign subsidiaries visited the California operation, inferentially for educational purposes, and technical

studies done in California were shared with foreign subsidiaries. The necessary "flow of value" existed.

B.

The operations of the foreign subsidiaries were unitary with plaintiff's United States' operations.

For purposes of this discussion, I apply the "three unities" test of *Butler, Supra,* which has been approved by the United States Supreme Court and has actually been described as "something of a benchmark against which other apportionment forumlas are judged". (*Container, Supra,* p. 170.)

1. Unity of Ownership.

Here there is no issue. Plaintiff either owned the controlling shares or owned outright each of its foreign subsidiaries.

2. Unity of Operation.

The whole purpose of the International subsidiary corporation of plaintiff was to run the International business and to make sure that its policies were enforced. It had a headquarters in New York where its president was located. There were three vice-presidents, one for the Western Hemisphere, one for Europe, and one for the Far East. In every case the general managers of the foreign subsidiaries reported to these divisional vice-presidents. The record is replete with evidence of visits to subsidiaries by International personnel and between subsidiaries. The organization was more of a large and happy family than a collection of balkanized states.

Plaintiff furnished its subsidiaries with raw material, information and equipment; aided in engineering problems; developed specific accounting procedures and policies; guaranteed loans; and, according to Mr. Foster, transferred its personnel around to effect its worldwide objectives. It transferred general managers from subsidiary to subsidiary, shared in

marketing experience and expertise and, to a small extent, offered its rather meager research and development knowledge to the subsidiaries. However, clearly, research and development was basically the responsibility of the subsidiaries who sometimes whomped up whatever they wanted or were able to develop in their own locale. I hope I am not painting a picture of too centralized in [sic] operation. Admittedly, for good business reasons, the subsidiaries were given the maximum degree of autonomy consistent with the overall control by the parent company.

What has been said of the relatively modest offering of the research and development aspect of the parent company can be said of its legal help to the subsidiaries. It offered a modest but important advice in the fields of patents and trademarks.

3. Unity of Use.

On this issue, the testimony of Mr. Foster, former C.E.O. of the company was particularly devastating to plaintiff's case. He made it crystal clear (in the longest televised deposition I ever attended) that in the capacity of C.E.O. he gave direction and maintained control in almost every major aspect of the local and overseas' business. Again, while he allowed the subsidiaries the maximum degree of autonomy because experience had shown that this was good for business, there was never any doubt that Big Brother, in the form of the formidable Mr. Foster, was always there looking over the subsidiary's shoulder.

He appointed, and could fire, the president of International who in turn appointed the division vice presidents who in turn hired and fired the general managers of the subsidiaries.

The budget review process is a good example of close supervision and control as was the requirement for approval of work orders and numerous other activities requiring approval

of the parent company. It would unduly prolong this discussion to recite each of these items. Suffice to say, the record is replete with examples of a well-organized and carefully carried out program of control by the parent company, while at the same time allowing the greatest degree of autonomy possible.

C.

It is clear that the "three unities" test has been met. At this point, the *Container* case answers any questions regarding the constitutional due process standards for state taxation.

Under these standards, the due process and commerce clauses of the U.S. Constitution do not allow a state to tax income arising out of interstate activities, even on a proportional basis, unless there is a "minimal connection" or "nexus" between the interstate activities and the taxing state. There must exist "a rational relationship between the income attributed to the state and the intrastate value of the enterprise". (*Container, Supra*, p. 159.) *Container* also held that "the prerequisite of a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods." (*Supra*, p. 178, emphasis in original.) *Container* also held that the contributions of income from the subsidiaries should result from "functional integration, centralization of management and economies of scale". (*Supra*, p. 178-179.) Last, *Container* held that the taxpayer has the burden of showing by "clear and cogent evidence" that the state tax results in extraterritorial values being taxed.

There is nothing to be gained by further discussion in this area. Suffice to say, the evidence of unitary business operated by plaintiff in this case is substantially stronger than that of the taxpayer in *Container*. *Container* is simply too strong a case on this issue for the plaintiff to overcome on the evidence presented in this case. If the Container Corporation was unitary, plaintiff simply has to be.

Plaintiff's reliance on *F.W. Woolworth Co. vs. Taxation and Rev. Dept.* 458 U.S. 354 is misplaced. In *Woolworth* "no phase of any subsidiary's business was integrated with the parent's." (*Supra* p. 365, emphasis in original.) *Container*, which on its facts was weaker on this issue than ours, distinguished its facts from *Woolworth*. (*Supra* p. 159.)

Plaintiff loses on the unitary argument.

II.

DOES THE APPLICATION OF THE "THREE-FACTOR" APPORTIONMENT FORMULA (PAYROLL, PROPERTY AND SALES) TO THE COMBINED INCOME OF COLGATE AND ITS FOREIGN SUBSIDIARIES VIOLATE THE "DISTORTION DOCTRINE"?

No.

Here, plaintiff is again confronted with the holding of the Supreme Court in *Container* where the Court on remarkedly similar facts found for the taxing agency.

The unitary concept recognizes that a unitary business must be treated as a single unit and that income cannot be segregated along geographic or corporate lines within the business.

In *Container*, the taxpayer made the identical argument made here, i.e. that its foreign subsidiaries were more profitable than the domestic parent company and that the three-factor formula ignored differences in profitability by its reliance on indirect measures of income such as payroll, property and sales. There, the taxpayer argued that the three-factor formula failed to account for differences in profitability and thus distorted the true division of income between the foreign subsidiaries and the parent entity.

The Court rejected this contention saying that "the profit figures relief [sic] on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." (*Container, Supra*, p. 181.) The Court went on to say that "formal accounting is subject to manipulations and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." (*Supra*, p. 164-156 [sic].) The Court observed that some kinds of formula apportionment have weaknesses because they focus on too small an aspect of the company's activities but that the three-factor formula has gained acceptance simply because its factors (Payroll, property and sales) "appear in combination to reflect a very large share of the activities by which value is generated." (*Supra*, p. 182-183.)

There, as here, the taxpayer argued that the differences in wages and productivity among domestic and foreign entities should be used to attack the three-factor formula. The Court said, "The problem with all this evidence, however, is that it does not by itself come close to impeaching the basic rationale behind the three-factor formula." (*Container, Supra*, p. 182.) The Court held that the margin of error inherent in the three-factor formula is no greater than the margin of error inherent in "the sort of separate accounting urged upon us by appellant." (*Supra*, p. 184-185.) (See also *John Deere Plow Co. vs. Franchise Tax Board*, 130 Cap.App.3d [sic] 15.) *Container* concluded that although "separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." (*Supra*, p. 181.)

On greatly similar facts, *Container* rejected each and every contention made by plaintiff in this case. Nothing would be gained and it would unduly lengthen this decision to dissect each and every contention made in this case and rejected by

Container. That case simply shoots down in flames each and every contention made by plaintiff on this issue.

The foregoing discussion of the first two issues in this case are those [sic] which I used in my Intended Decision filed earlier. When the time came for counsel to file proposals for content of decision, my discussion of Issue I, the Unitary Issue, passed with flying colors, each party accepting it and agreeing that my intended decision serve as the Statement of Decision on this issue. Not so on the remaining two issues.

As to Issue II, the Distortion Issues; Defendant finds itself satisfied with the foregoing. Not so with the plaintiff, which has some suggestions for separate specific findings, some of which sound suspiciously like interrogatories and some of which request findings of evidentiary rather than ultimate facts. However, some deserve further comment.

In my discussion of this issue, I took a shortcut and simply adopted much of the language and all of the rationale of *Container* because I felt that that language and that rationale answered completely each of plaintiff's contentions. However, my shortcut was too short for plaintiff. As plaintiff points out, *Container* was concerned only with the distortion analysis under the Constitution and did not involve Section 25137. (See Footnote 3 in *Container*.) Nevertheless, I thought and still think that *Container's* discussion of the distortion doctrine was so persuasive that it answered plaintiff's contentions whether addressed to the Constitional issue or Section 27135. That was my intent and to make the matter clear beyond any doubt, I now specifically hold that the rationale in *Container* provides an adequate answer to plaintiff's contentions re: Section 25137. That rationale, as applied to the facts of this case, support [sic] the finding of the Board on the Section 25137 issue. Specifically, I find that Section 25137 does provide for modification of the standard formula where that formula does not fairly reflect the extent of the taxpayer's business activities in

the state. Also, Section 25137 lists separate accounting as an alternative to the three-factor formula when that formula does not fairly reflect the extent of the taxpayer's business activities in the state.

I further find that separate accounting may under some circumstances be used as an alternative to the normal apportionment formula where the taxpayer is part of a unitary group.

I further find in regard [sic] the taxable income, California apportionment percentage, California business income and total franchise tax under the three-factor apportionment formula as applied by the defendant board to the worldwide combined group, that the following computations are accurate:

Income Year	Taxable Income	California Apportionment Percentage	California Business Income
1970	$ 91,566,729	4.42075%	$4,047,936
1970	108,177,612	4.12017%	4,457,101
1971	123,779,352	4.03444%	4,993,803
1973	151,585,860	3.71812%	5,636,144

Income Year	Franchise Tax
1970	$283,356
1971	311,997
1972	379,529
1973	467,800

I also find the following to be the taxable income, California apportionment percentage, California business income and franchise tax resulting from application of the water's-edge separate accounting approach presented by Colgate in this case:

Income Year	Taxable Income	California Apportionment Percentage	Business Income
1970	$25,652,055	9.31920%	$2,390,566
1971	27,520,141	9.01730%	2,481,574
1972	32,440,358	9.21640%	2,989,833
1973	36,554,060	8.88730	3,248,669

Income Year	Franchise Tax
1970	$167,340
1971	173,710
1972	227,227
1973	269,640

I also find that utilization of worldwide apportionment by defendant board increases plaintiff's taxable income by approximately 70% for the years 1970 through 1973 over plaintiff's taxable income as computed on a water's-edge combined apportionment. This is simply a mathematical result of combining stipulated figures but is somewhat meaningless since it fails to reflect operational interdependencies, economic inter-

dependencies and functional integration between and among Colgate's worldwide unitary business.

I also find that plaintiff's labor cost and property cost per unit of product are substantially less than the comparable costs for the foreign subsidiaries. Again, this becomes rather meaningless since it fails to reflect the flow of value concept of *Container*.

I also find that the foreign subsidiaries were more profitable than plaintiff's domestic operations, again with the above caveat.

I further find that the normal three-factor apportionment formula does not necessarily produce an exact representation, in an economic sense, of the separate incomes of related entities. Neither, necessarily, does the separate accounting method. Both are imprecise.

Having made the specific findings that plaintiff has requested, we now find ourselves back at square one, plaintiff still loses on this issue. As I said originally, *Container* shoots down in flames each and every contention made by plaintiff on this issue.

It is to be remembered that the issue presented to me is whether the Board properly exercised its discretion in denying plaintiff's petition. Once it has exercised its discretion within the scope of the statute, that decision will not be disturbed by this court unless the court can find an abuse of discretion, an uphill battle under the best of conditions. Here, the Board held two hearings — the board itself not the staff. The Board found that plaintiff had made no showing that the standard apportionment formula unfairly reflected the extent of plaintiff's business activities in California. It also found that plaintiff used impermissible separate accounting measures in attempting to establish distortion. I cannot, on the basis of the record before me, overturn those findings.

I will not repeat the discussion of this issue as set forth in pages ten to twelve of this Statement of Decision. *Container* made it clear that no system is perfect, imperfection is build [sic] into both, formal accounting is subject to manipulation and imprecision and often "ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." (*Container*, p. 181.) Here we had the testimony of a believable expert that plaintiff's methodology failed to reflect that same flow of value from the domestic operations to the foreign subsidiaries.

Realistically, when one accepts, as indeed we must, *Container's* flow of value rationale, it becomes apparent that the taxpayer faces an extremely uphill battle in showing distortion. All I can say is that there was not displayed to me substantial evidence of distortion under the rationale of *Container*. The distortion that was shown is well within the level found acceptable by *Container*. The board acted well within its discretion in ruling against plaintiff on the distortion issue.

Having disposed of the two issues rendered relatively simple by *Container*, I proceed to the real meat of this lawsuit, the constitutional issue.

It is to be remembered that at the start of trial, I suggested to counsel that the issues be bifurcated and this issue be disposed of first because, should I rule for the plaintiff on this point, the other issues become moot. However, it was agreed that all issues be tried and decided because of the age of the litigation and the great expense already incurred in preparation. Thus, should I rule for plaintiff on this issue and should, by some horrible miscarriage of justice, a reviewing court disagree with me, the other two issues would be ripe for review. I now proceed to the constitutional issue.

III.

DOES DEFENDANT'S UNITARY METHOD OF TAXATION OF MULTINATIONAL CORPORATIONS IMPERMISSIBLY INTERFERE WITH THE FEDERAL GOVERNMENT'S POWER TO CONDUCT FOREIGN AFFAIRS?

Yes.

On this issue, the defendant, having won two battles, now loses the war. To be more accurate, the issue on which it loses was decided some two hundred years ago when thirteen highly independent former British colonies decided to abandon a confederation type of government and become the United States of America and, in so doing, adopted a new, vital and strong Constitution.

When these fledgling states adopted the new Constitution, they gave up certain rights. Among them was the right, as individual states, to regulate commerce with foreign nations. Now, only the new Federal Government could do so (Art. I., Sec. 8, *United States Constitution*.) Under this new Constitution, the country could speak with only one voice in dealing with foreign nations, not thirteen (or fifty) voices. Any state practice which impaired federal uniformity where federal uniformity was essential became unacceptable under this new system of government. In our case, California's application of the unitary method of taxation to a multinational corporation conflicts directly with the foreign policy of the federal government which is that the separate accounting, or water's edge, or arm's length accounting, is the appropriate method.

The unitary method of taxation is not widely used. In international circles it is not used at all in the taxing of multinational corporations. The water's edge method is now used. Even California has all but abandoned the unitary method of taxing multinational corporations since the taxpayer now has

his choice of methods and it is highly doubtful that a case such as this will ever arise again.

In the water's edge method the income of the foreign subsidiary is not thrown into the computation. Under it, multinational corporations pay less state taxes. However, for policy reasons involving the concept of free trade and with which we may not concern ourselves, the water's edge accounting method is now the expressed policy of the executive branch of the federal government. As a necessary corollary, it is also the expressed policy of the executive branch of the federal government that states not use the world-wide unitary method of computing taxes of multinational corporations. The President of the United States has said so. (Exh. 1.) So has the Secretary of State. (Exh. 2.) So has the Secretary of the Treasury. (Exh. 3,4.) And, last but not least, so has the Attorney General. (Exh. 5, 9 20.) Their objections to the unitary method can be summaried as:

(1) It impermissibly interferes with the conduct of foreign affairs by the executive branch of the federal government.

(2) It has caused conflicts between the United States and foreign nations and has led to the adoption of retaliatory legislation.

(3) It contravenes established federal policy in the field of foreign affairs.

It is well established that a state cannot act in such a way as to prevent the federal government from "speaking with one voice" in international affairs. (*Japan Lines vs. The County of Los Angeles*, 441 U.S. 434.) As the court in that case said: "California cannot tell this nation nor Japan how to run their foreign policies." Obviously, each of the fifty states cannot go merrily on its way establishing foreign policy. Otherwise, we

go back to the confederation. This principle is so obvious that it deserves no further comment.

Container, which effectively won defendant's first two contentions in this case, neatly dodges this issue by saying that the position of the federal government had not been made clear because it had not filed a brief in that case. (*Container, Supra*, footnote 33.) The dissent thought this had been established and chided the majority for not facing up to it. In our case, the position of the executive branch of the federal government is now crystal clear.

Defendant poo-poos the statements of the executive position on this issue as being mere press releases and letters. True. However, they are mighty strong and explicit press releases and letters. They clearly express the policy of the executive branch. It is their substance that counts, not their form. I think they clearly express executive policy on this issue.

In his public statement on this subject, the President of the United States instructed the Secretary of the Treasury to pursue through legislation and the Attorney General to pursue through litigation, the federal policy that multinational corporations be taxed by states only on income derived from the United States and not on income derived from foreign subsidiaries, i.e. the unitary method. Interestingly, the statement does not distinguish between cases involving U.S. parent corporations and those involving foreign parent corporations. The condemnation of the world-wide unitary method applies to all instrumentalities of foreign commerce, not just foreign based corporate groups. Actually, when the principles of water's edge accounting are accepted, it is difficult to rationalize any distinction. I can't. I find that the so-called "U.S. vs. foreign corporations" issue is a non-issue.

The letter from the Secretary of State to the Governor of California minced no words. Not only did it say that it was the longstanding policy of the United States to follow the separate

accounting method but that, "Your state's employment of the world-wide unitary method of accounting is at odds with the position of the United States and has become a source of conflict with foreign states." The letter of the Secretary of the Treasury further detailed the detrimental effect of the continuance of the world-wide unitary method on United States foreign policy.

The Attorney General has been carrying out executive policy in filling [sic] *amicus curiae* briefs on the subject in some cases and, in Alaska, which follows the California system, has even filed a lawsuit seeking a determination that the unitary method is unconstitutional on the specific grounds urged here.

But, say the defendants, the Attorney General has not filed a brief in this case. True. Instead, that office wrote two letters which simply stated that the positions expressed in prior briefs still expressed its views. One could speculate until doomsday just why the Attorney General took this tack. The bottom line is that he still made the position of that office and the executive branch of the federal government clear on this issue.

On this record it is impossible to say that the executive branch of the federal government has not spoken clearly. It is the policy of the United States, speaking through the executive branch, that the water's edge system be followed and the unitary method discarded. One would think that in view of the commerce clause and *Japan Line*, the discussion would be pretty conclusively ended. Not so.

Defendant contends that *Wardair Canada vs. Florida Department of Revenue*, 447 U.S. 1 compels a ruling in its favor on this issue. Not so.

Wardair involved a challenge by a Canadian airline operating charter flights to and from the United States to a Florida tax imposed on all aviation fuel sold within that state. Under the Florida law, an airline was liable for the full amount of the

fuel tax, whether the fuel was used to fly within or without Florida, and regardless of whether the airline was engaged in a substantial or nominal amount of business in Florida. The *Wardair* court affirmed the validity of the Florida law, holding that the federal government had affirmatively acted in such a way as to permit the state tax in question by enacting legislation which permitted state taxes on sales or use of goods or services in connection with air commerce. The court said:

> "In the present case, not only is there no indication of airline fuel that Congress wishes to preclude a state sales taxation of, but, to the contrary, the Act expressly permits states to impose such taxes."

(*Supra*, p. 6.)

Here, the federal government, acting through the executive branch, has acted affirmatively in showing a federal determination that the tax in question is contrary to federal policy.

Next, defendant argues that *Container* is controlling on this issue and that the analysis by *Container* of the commerce clause compels a ruling in its favor on this case. Not so. *Container* made it very clear that it based this aspect of its ruling on the fact that the federal government had not taken a position on this subject, a holding with which the dissent took issue. I repeat, *ad nauseam*, the executive branch of the federal government has now made its position clear and that, if the executive branch has that power, this is now the national policy on the subject.

And so, at long last, we come to the decisive question. Can the executive branch of the federal government establish national policy by itself or does it need the concurrence of the legislative branch? I think it can — and without the concurrence of the legislative branch.

Without question, the *legislative* branch can establish national policy without the concurrence of the executive branch.

The legislative branch is the pre-eminent branch of the national government. It can express policy and the executive branch must carry out that policy whether it likes it or not. If congress declares ware [sic] on the Kingdom of Tonga, the President goes to war with Tonga, period. We have recently been exposed to a classic example of legislative pre-eminence in the so-called "Contra affair." The executive branch was gung-ho for aiding the Contras and did so with great enthusiasm until congress acted to the contrary, at which point the aid came to a screeching halt — or at least — was supposed to. But how about the period before congress acted? Did the failure to act indicate congressional approval of executive policy? I doubt it. Did it express disapproval? Again, I doubt it. I don't think one can read anything into that congressional inaction. But once congress acted we *knew* what the national policy was and the executive branch was bound to follow that new national policy whether it liked it or not.

In our case, we have a strong position taken by the executive branch, which, for reasons which cannot concern us, has established a policy in the field of foreign commerce it feels will aid it in its relations with foreign nations. Only a few states (now only Alaska) stood in the way of this nation "speaking with one voice" in expressing and carrying out that policy. Is that policy now fatally flawed because congress has not acted? No way.

If Congress were to enact legislation to the contrary, that would end the matter. It has not. Failing to find active congressional support for its position, defendant falls back on a theory that in enacting certain legislation in this field or approving treaties in this field, congress has omitted from that legislation or those treaties or struck from them, language which would support the position of the executive branch in this field. From this congressional "action" defendant asks me to find that there is no federal policy in this field. This I cannot do.

In the first place, I have difficulty reading too much into any failure of congress to enact legislation. Trying to ascertain legislative intent after affirmative action by the legislature is bad enough. At least we know that the legislature has acted and now we have to try and find out what it meant by that action. However, when the legislature doesn't act, I have great difficulty in reading into that inaction any controlling policy. Congressional silence is a weak reed on which to lean. (Incidentally, for what it's worth, I agree with the defendant in its analysis of *Hampston vs. Mow Sun Wong*, 426 U.S. 88. There the executive branch *had* legislative authorization for its' [sic] action.)

Defendant says such a ruling would nullify the constitutional system of checks and balances which, for example, requires Senate approval of all treaties negotiated by the executive branch. Granted, the executive branch cannot enter into a binding treaty without Senate approval. But does that mean that each and every act of the executive branch which may express national policy in the international field needs congressional approval before it can truly express national policy? I think not. I haven't the foggiest idea of the innumerable positions the executive branch of the federal government must take in the fields of international relations or foreign commerce on an almost day-by-day basis, but to me it is pretty obvious that it can't run to congress on every one for approval or disapproval. For example, as *Witkin* says (*5 Witkin, Summary of California Law*, 8th Ed. p. 3974) "While treaties require the consent of the Senate, international compacts such as protocols, postal conventions and commerce agreements under the Tariff Act, are negotiated by the executive branch without senatorial consent. A compact is an exercise of federal power over external affairs and has the same supremacy as a treaty over state laws and policy. (*U.S. v. Belmont*, 301 U.S. 324; *U.S. v. Pink*, 315 U.S. 203)."

But, says the defendant, in this case we have much more than just legislative silence, we have a history of legislative inaction which actually amounts to action. For lack of a better phrase, I would classify this theory as one of dynamic inaction or affirmative silence.

Defendant lists five examples of legislative inaction which amount to dynamic inaction or affirmative silence. These, defendant contends, amount to positive action to the extent that they establish a legislative policy in favor of allowing the states to use the unitary method rather than the water's edge method of taxation of multinational corporations. Thus, we see that we have proceeded from the theory that the executive branch cannot establish federal policy without Legislative concurrence to a theory that in this case we have a history of legislative inaction that affirmatives create a federal policy. While the theory has a certain cosmetic appeal, I can't buy it.

Plaintiff in its closing brief has accurately and fairly listed the item [sic] of evidence on which defendant relies in support of this assertion. They are:

(1) Failure to consider state taxes at all in any income tax treaties with foreign countries.

(2) Failure to obtain the necessary two-thirds vote to ratify a treaty containing a provision prohibiting use of the worldwide unitary method by the states.

(3) The absence of any provision restricting state taxes of any sort in various model income tax treaties.

(4) The absence of restrictions on state taxation in Friendship, Commerce and Navigation Treaties to which the United States is a party.

(5) the absence of enacted congressional legislation prohibiting or restricting the world-wide unitary method.

Of these, the incident that most graphically articulates and is most supportive of defendant's position is the tax treaty with the United Kingdom which would have prohibited the state's use of the world-wide unitary method. When the negotiated treaty came before the Senate for ratification, the Senate refused ratification with that article included and ratified the treaty only after that provision was deleted. From this, defendant contends that the Senate action on the offending clause demonstrates there "is a long-standing federal policy to allow the states to use world-wide unitary method without federal interference." I am unimpressed.

The executive branch of the federal government is monolithic. It truly speaks with one voice in setting policy. When the President speaks, that *is* the voice of the executive branch. But until the legislative branch takes affirmative action after a consensus has been reached and passes a resolution, enacts legislation, ratified [sic] a treaty or declares war, it is a hydra-headed monster consisting of hundreds of individual voices, each of which has its own reason for speaking. It is a figurative Tower of Babel until a majority of those voices joint [sic] together in a chorus. Until that time, a single legislator or even a group of legislators cannot establish legislative policy.

Pending affirmative action by the majority, or two-thirds, we can only speculate as to the reason that less than a majority or less than two-thirds, did not act. Does it mean that the legislature is postponing action? Does it indicate legislative indifference? Is it a political gambit to embarrass the Executive? Is the legislative branch simply giving the executive branch enough rope to hang itself? Does it indicate that the legislative branch is waiting for a more politically propitious time to act? Does it indicate Legislative approval by its silence? Does it represent legislative disapproval? Does it mean an intent to act in the future? Are political debts being paid off?

The possibilities, the political nuances, are endless. In trying to assess legislative inaction or failure to act, we get into fields of pure speculation. We try to weigh imponderables. We quibble, we split hairs, we guess, we surmise, we pick nits. Trying to define or identify legislative policy from inaction is hazardous to the extreme.

I just can't read any policy statement into legislative inaction or failure to act. Attempting to do so would result in complete chaos as we try to read into congressional inaction any policy, in this case, one that would clearly express executive policy.

In other words, I don't know why congress failed to enact the legislation or struck from the legislation the language it did in the above five categories. I certainly can't find a legislative policy from that inaction. Once policy has been established by affirmative majority action, we need not bother ourselves by trying to guess why the action was taken. At that time the reason for the policy becomes irrelevant except from the standpoint of eventual statutory interpretation. I can't read federal policy into all or any of the five examples. If congress wanted to express a policy contrary to that expressed by the executive branch it could easily have done so. It hasn't. If the legislative branch had a policy of allowing the states to use the world-wide unitary method without federal interference it could easily have done so in any or all of the listed legislation treaties. One simple sentence in any of these would have shown legislative policy to that effect. One can search these pieces of legislation and those treaties in vain for any such statement of legislative policy.

In summary, I find that the executive branch of the federal government has clearly expressed a federal policy supporting the principle of water's edge taxation of multinational corporation and disapproving the world-wide unitary method, that the executive branch can do so without legislative concurrence

and that the legislative branch has not expressed a contrary policy. Thus, inescapably, defendant's unitary method of taxation of multinational corporations impermissibly interferes with the federal government's power to conduct foreign commerce and is thus unconstitutional.

Again, the foregoing is simply a copy of my Intended Decision filed earlier. As might be expected, Plaintiff accepts it in its present form and, I dare say, would compare it favorably with the best work of Oliver Wendell Holmes. It has been my experience throughout the years that winning lawyers are inclined to look more favorably at a judge's offerings than the losing lawyer. Strange.

However, defendant requests some specific findings, most of which I think are to be found buried in the foregoing flow of judicial rhetoric but, as I did with the plaintiff, I will attempt to make specific findings as requested, at all times watching my footsteps as carefully as possible to avoid getting a tad of reversible error in the record by way of an inconsistent finding. There is a wide-spread feeling among trial judges that this is usually the reason for requests for specific findings by the losing party. In this case, I hold no such such suspicion concerning counsel for the defendant, nor do I concern [sic] requests of plaintiff's counsel for findings on Issue II.

First, defendant asks, if such interference (interference with the federal government's power to conduct foreign affairs) exists, what precise policies of the Federal Government are interfered with by the application of the unitary method of taxation of domestic-parent multinational corporations.

Answer: That policy of the Federal Government that multinationals — whether domestic-parent or foreign-parent — be taxed by states only on income derived from the territory of the United States — the so-called waters edge method of taxation, not by the application of the so-called unitary method used by certain states.

Next, plaintiff requests specific findings on a series of related questions. (1) what date or dates were the policies specified above adopted by the federal government and which items of evidence establish such adoption? (2) if such interference does exist, what date was such interference manifested? (3) if such interference does exist, which items of evidence show such interference?

Plaintiff objects to this request pointing out that these issues were not "controverted issues" at trial, that Sections 632 and 634 of the Code of Civil Procedure relate only to a statement of decision on controverted issues and since this was not a controverted issue, no further statement is necessary.

There is certainly merit to plaintiff's position. These issues were not even mentioned, let alone litigated at trial although I must admit that I was a bit puzzled that the defendant didn't bring it up.

I really thought that when plaintiff introduced the exhibits showing the actions of the Federal Government in setting forth this policy in the 1980's, the defendant would say something to the effect that although this may have been the articulated policy during the 1980's, there was no evidence that that policy existed during the taxable years in question — 1970-1973. However, I was never one to try to tell lawyers how to try their lawsuits so I decided that if the lawyers thought this was a non-issue, it was a non-issue. Now, somewhat belatedly, defendant attempts to make this an issue. I repeat, I have again read and reread defendant's pre-trial and post-trial briefs and still cannot find a single word making this an issue. In all honesty and fairness, it does appear that if defendant was to make this a "controverted issue" it should have done it long before the Intended Decision was filed. Then, if I thought it had merit I might well have re-opened the case to explore this issue.

However, in answer to this defendant contends, as might be expected, that plaintiff, the party with the burden of proof,

was required to show both the fact of interference with foreign policy, and the relationship of that interference to the tax years in question. It points out that *Container*, issued in 1983, held that at that point in time there was no constitutional interference with federal policy. Of course, *Container* made no such holding. It simply dodged the issue. I should point out that in *Container* the taxable years in question were 1963-1965, and I haven't the foggiest idea whether this was ever made an issue as that case wended its way through the courts.

Nevertheless, it is clear to me, and I now find, that the only reasonable inference I can draw from the record in this case, that the policy existed long before the taxable years in question. Certainly, the Supreme Court in *Container* didn't seem much impressed with this as an issue. I turn to that record.

In 1985 and 1986, probably in response to *Container* which must have come as something of a shock to the Federal Government when it dodged this issue, that government, just to set the record straight, issued a series of statements setting forth its policy in no uncertain language.

On November 8, 1985, the President issued his statement supporting the concept of water's edge taxation and advising that since some states had not accepted that principle he had advised certain of his subordinates to see to it that that policy was carried into effect by the states.

I doubt that on the morning of November 8, 1985, Ronald Reagan woke from a tranquil sleep and said to himself, "By George, I have just had a new, novel and remarkable revelation. The unitary method of taxation used by some of the states, to the embarrassment of the Federal Government, must go!" Rather, the only reasonable inference I can draw is that a longstanding federal policy in this regard was being ignored by certain states to the chagrin of the federal government in its relations with other commercial nations and the President de-

cided it was high time those states get in line with that federal policy, particularly after the *Container* decision.

That inference is reinforced by the letter of the Secretary of State to the Governor of California of January 30, 1986 to the effect that it had been the *"longstanding policy"* of the Federal Government that the water's edge method of accounting be used and it was his request to the Governor of California that this state please join the Federal Government in this respect.

Then, on March 5, 1986, the Secretary of the Treasury Department wrote the Chairman of the Senate Finance Committee reiterating the inconsistency of the world wide unitary method used by some states with the *"longstanding"* United States foreign policy and emphasizing that the California method was inconsistent with that federal policy. At that time, there were still seven states using the unitary method — there had been more — but the federal program was apparently working insofar as getting rid of the troublesome states because as of now only one state, Alaska, is still holding out and the Attorney General, by litigation, is now trying to get that state in line. The only reasonable inference I can draw from this record is that the federal government has indeed had a longstanding policy in this respect and has been engaged in a long range program to do away with the unitary method.

This, "longstanding policy" that has been the policy of the federal government in its relations with other commercial nations is the one used by the Internal Revenue Code for many years and is the one used in all the bilateral tax treaties entered into between this nation and the commercial countries of the world dating back to the 1950's although these treaties obviously speak only to the federal government's policy. I doubt that such a treaty could be binding on a state. Rather, the federal government had to reach the states by persuasion and/or

litigation to get them in line. This is going and has been going for a long time.

On this record I cannot fix the precise date on which this federal policy was established. Like Topsy, it "just growed." In general, I presume that it came into being shortly after World War II and the change of national policy from that of high tariffs and protectionism to one of free trade. I think it would take a task force of historians, researchers and economists armed with a grant larger than the tax liability involved in this case to trace down the precise date this policy was first announced and I doubt that such a precise date would ever be established.

Sometime, probably shortly after World War II, some representative of a multinational corporation undoubtedly complained to someone in the Executive Branch of the federal government that the use of the unitary method of taxation was inconsistent with the waters-edge method used by all commercial nations and the federal government of the United States. This triggered a program that has been going on long before the taxable years in question to persuade the states to abandon that method of taxation. When was that precise date? I don't know, probably in the 1950's because the tax treaties go back that far.

Thus, the only reasonable inference I can draw is that this federal policy was adopted long before the taxable years in question. I am sure it was before the taxable years 1963-1967 in *Container*.

Last, defendant asks, if such interference does exist, which specific provisions of the Federal Constitution were violated by such interference?

Answer: the Commerce Clause and the Supremacy Clause.

The claim for refund will be allowed.

Plaintiff is to prepare a judgment carrying this decision into effect. It is suggested that counsel for plaintiff and counsel for defendant collaborate in the form of this judgment so that the appeal rights of each are protected.

DATED: 4/19/89

ROBERT GARDNER
Judge Pro Tem

APPENDIX G

RULE 29.1 LIST

COLGATE'S LESS THAN 100% OWNED SUBSIDIARIES

Subsidiary	Ownership Interest
Colgate-Palmolive Ges.m.b.H.	98.10%
Dental-Pack Industria e Comercio Ltda	50.00
Chemtech (B.V.I.) Co., Ltd.	50.00
Dentatech (B.V.I.) Co., Ltd.	50.00
Hawley & Hazel (B.V.I.) Co., Ltd.	50.00
Oraltech Company Ltd.	50.00
Gervas Brunei (Sdn. Bhd.)	59.50
Colgate (Guangzhou) Co. Ltd.	65.00
Colgate-Palmolive & CIA, en C.S.	99.00
Colgate-Palmolive del Ecuador, S.A.	73.00
Industrias Quimicas Asociados Multiquim, S.A.	73.00
Colgate-Palmolive (Eygpt) S.A.E.	91.51
Colgate-Palmolive France	99.98
Cotelle S.A.	99.94
C.P. Holding S.A.	99.76

Subsidiary	Ownership Interest
Mennen France S.A.	50.00
Societe Alta	99.76
Societe Bella	99.76
Societe Delpha	99.76
Societe Industrielle de Detergents et Applications Chimiques	34.33
Colgate-Palmolive GmbH	98.13
Dan-Chemie GMBH	98.13
Asian Pioneer Co., Ltd.	50.00
Colgate-Clorox (Far East) Ltd.	50.00
Hawley & Hazel Chemical Co. (Hong Kong), Ltd.	50.00
Hawley & Hazel Investment Co., Ltd.	50.00
Camelot Investments Co. Ltd.	40.00
Colgate-Palmolive (India) Ltd.	40.00
Jigs Investments Ltd.	40.00
Multimint Leasing & Finance Ltd.	40.00
Passion Trading & Investments Ltd.	40.00
Prudential Securities & Financial Trust Pvt. Ltd.	40.00
P.T. Colgate-Palmolive Indonesia	51.00
Mennen S.p.A.	50.00

Subsidiary	Ownership Interest
Viset SRL (formerly Viset S.P.A.)	49.00
Colgate Palmolive Cote D'Ivoire	99.17
Colgate-Clorox Malaysia SDN. BHD.	50.00
Colgate-Clorox (Malaysia) Industri SDN. BHD.	50.00
Colgate-Palmolive (Malaysia) SDN. BDH.	85.00
Colgate-Palmolive (M) Marketing SDN. BHD.	85.00
Gervas Corporation Malaysia Sdn. BHD.	59.50
Hawley & Hazel (Malaysia) SDN. BHD.	50.00
Puterang SDN. BHD.	35.00
Syarikat Tahara Sdn Bhd	85.00
Zaitun Industri Makanan SDN. BHD.	42.50
Zaitun Industri SDN. BHD.	42.50
Zaitun Marketing SDN. BHD. (formerly Zaitun Holdings SDN BHD)	42.50
Colgate-Palmolive Pakistan (formerly National Detergents Ltd.)	30.00
Colgate-Palmolive (PNG) Pty. Ltd.	49.00
Endeavon (PNG) Pty. Ltd.	49.00
Colgate-Palmolive Poland	55.00
Societe Industrielle de Bourbon	51.00
Colgate-Palmolive Romania	60.00

Subsidiary	Ownership Interest
Colgate-Palmolive Arabia Ltd.	49.00
Colgate-Palmolive Senegal	62.94
Hawley & Hazel Chemical Co., Singapore (Pte.), Ltd.	50.00
CHET Household Products (PVT) Ltd.	80.00
Hao Lai Chemical Co., Ltd.	50.00
Hawley & Hazel Taiwan Corp.	25.00
Siam Green Consumer Products, Ltd.	49.00
Siam Regal Co., Ltd.	24.50
Baser Kimya San. Ve Tic. A.S.	45.00
Baser Tuketim Maddeleri Paz, Vet Tic. A.S.	45.00
Colgate-Palmolive Haci Sakir Sabun San. ve Tic. A.S.	67.00
Gervas Corpn Int Ltd (formerly Gervas (Vanuatu) Limited)	68.00
Colgate Finance S.N.C.	99.67
Bromo Industrial	33.00

No. 92-1839

Supreme Court, U.S.
FILED
JUL 16 1993

In The

Supreme Court of the United States

October Term, 1993

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeals Of The State Of California In And For The Third Appellate District

BRIEF OF RESPONDENT FRANCHISE TAX BOARD IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

DANIEL E. LUNGREN
Attorney General of the
State of California

TIMOTHY G. LADDISH
Assistant Attorney General

LAWRENCE K. KEETHE
Supervising Deputy Attorney
General

CLAUDIA K. LAND
Supervising Tax Counsel
Franchise Tax Board

JOHN D. SCHELL
Deputy Attorney General
(Counsel of Record)
P.O. Box 944255
Sacramento, California 94244-2550
Telephone: (916) 324-5165

Attorneys for Respondent

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COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTIONS PRESENTED

1. Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant Commerce Clause, may be found by implication from congressional actions.

2. If a dormant Commerce Clause analysis were appropriate, whether worldwide combined reporting as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the foreign Commerce Clause.

3. Whether a purely prospective application should be made of any decision on the merits which concludes, contrary to this Court's existing precedent, that California's worldwide combined reporting tax method is unconstitutional as applied to a domestic-based business.

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STATUTORY AND CONSTITUTIONAL PROVISIONS

Article II, section 2, clause 2 of the United States Constitution (in part):

> "[The President] shall have power, by and with the advice and consent of the Senate, to make treaties, provided two-thirds of the Senators present concur. . . . "

SUPPLEMENTAL STATEMENT OF THE CASE

Pursuant to Rule 15.1, the Franchise Tax Board supplements Colgate-Palmolive Company's statement of the case to point out omissions and inaccuracies. Initially, it must be noted that this case does not raise any "issues of profound national and international significance regarding the states' power to require multinational corporations to report their income on a worldwide combined basis." (Petition, pp. 2-3.) Those issues, to the extent they are raised, and to the extent they may be of "profound . . . significance" are raised in the *Barclays* case (*Barclays Bank Int'l.* v. *Franchise Tax Bd.*, 2 Cal.4th 708, 8 Cal.Rptr. 2d 31, 829 P.2d 279 (1992) *on remand*, 11 Cal.App.4th 1678a (3d Dist. 1992) *petition for cert. filed sub nom. Barclays Bank PLC* v. *Franchise Tax Board*, 61 U.S.L.W. 3621 (Feb. 22, 1993) (No. 92-1384)). The issues Colgate attempts to raise in this case have already been conclusively decided in the decisions of this Court in *Container Corporation of America* v. *Franchise Tax Board*, 463 U.S. 159 (1983) (hereafter *Container*); *Wardair Canada* v. *Florida Department of Revenue*, 478 U.S. 1 (1986) (hereafter *Wardair*) and *Itel Containers International Corp.* v. *Huddleston*, ___U.S. ___, 113 S.Ct. 1095 (1993) (hereafter *Itel*).

At Petition, page 5, Colgate states that California's worldwide combined reporting method of taxation has been opposed by various taxpayers and foreign governments "because of its disregard of the established international norm of tax accounting." Colgate fails to note that such opposition is also based on the greater tax liability that may be incurred under the California system (see e.g., Statement of the United Kingdom before the United States Treasury Working Group on Worldwide Unitary Taxation, Stip. ¶ 38a) and that the purported international norm "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." (*Container* at 164-165.)

Colgate states "it has been the expressed policy of the federal government to oppose the states' use of the worldwide combined reporting method of taxing multinational corporations because of that method's impact upon relations with foreign nations." (Petition, p. 6.) Colgate fails to mention that the cited expressions of opposition (statements and letters) were not made in the context of this domestic-parent case,[1] and do not constitute formal statements of policy from the federal government as a whole, but emanate only from certain members of the Executive Branch. Nor does Colgate mention the many instances wherein Congress considered the issue of the worldwide combined reporting method, but declined to proscribe its use. (See Petition, Appendix B, p. 16a.) Most significantly, Colgate omits any mention of the fact that the U.S. Senate refused to ratify the United States-United Kingdom Tax Treaty until the provision which would have prohibited use of the worldwide combined reporting method was deleted. (See Petition, Appendix B, p. 16a; Appendix E, p. 45(a).)

---

[1] The Brady letter, although referring to this domestic parent case (Petition, p. 6, fn. 11) addresses the issues as a matter of *tax policy* rather than foreign policy.

SUMMARY OF THE ARGUMENT

Colgate, in its petition for certiorari, attempts to ride the coattails of the petitioner in *Barclays Bank (Barclays Bank PLC* v. *Franchise Tax Board,* Docket No. 92-1384). It does so because in the present case brought by Colgate itself, all relief is barred by this Court's decision in *Container.* Regardless of whether this Court decides to hear the *Barclays* case there is absolutely no reason for it to revisit the issues it decided only ten years ago in *Container.* In analytical terms, *Colgate is Container;* Colgate's case has been decided, and its suit for refund must fail.

Colgate argues that the decision below misreads and misapplies this Court's decision in *Wardair* in holding that Congress has authoritatively permitted the tax at issue here and that therefore no dormant Commerce Clause analysis is necessary. Assuming arguendo that Colgate were correct and that dormant Commerce Clause analysis were appropriate, Colgate still cannot prevail because in *Container,* this Court has already undertaken dormant Commerce Clause analysis of the application of the worldwide combined reporting as applied to a domestic-based multinational and has found the tax to be constitutional.

Quite significantly, this Court very recently has answered Colgate's question No. 1 (Petition i) affirmatively in *Itel,* at 113 S.Ct. 1105, wherein the inference of congressional intent to permit the tax at issue in that case is drawn from the congressional failure to proscribe it. As noted by Justice Blackmun in his lone dissent, the *Itel* majority finds "authorization for the tax in congressional silence." (*Id.,* 113 S.Ct. 1110.)

Colgate argues that the federal government has now supplied a statement of its position – the "missing evidence" that was absent in *Container.* The "evidence" Colgate relies upon for this assertion – a presidential press announcement; a letter from Secretary of State Schultz to Governor Deukmejian; and a personal letter from Secretary of Treasury Brady to the CEO of Colgate, Reuben Marks – cannot reasonably be considered to be an embodiment of the federal "*law* as it presently stands." (See *Wardair* at 477 U.S. 10; emphasis in original.) Nor is there any reason to infer from this Court's decision in *Container* that the decision would have been different if there had been such "evidence" of the views of the Executive Branch at the time of that decision.[2]

Colgate's argument for equal treatment is predicated upon the dual assumptions that this Court will grant the *Barclays* petition and will overturn worldwide combined reporting as applied to a foreign-based business. Neither event has occurred, nor is there any likelihood that they will occur. This issue is not ripe for this Court's review.

In sum, Colgate's question concerning congressional silence has been answered by *Itel.* However, even if Colgate were to prevail in its argument that dormant Commerce Clause analysis is called for in this case, it loses.

---

[2] In *Container* this Court stated at 463 U.S. 195-196 that the failure of the Executive Branch to file an amicus brief was "by no means dispositive." See also *Wardair,* wherein this Court had before it an Executive Branch amicus brief in opposition to the tax (*id.,* 477 U.S. at 9, 11) but relied entirely on the implications of *congressional* action in reaching its decision.

This Court engaged in dormant Commerce Clause analysis in *Container* and found the tax to be constitutional. Colgate presents no new evidence of any probative value to this issue. There is absolutely no reason for this Court to accept this case for review.

Finally, in the unlikely event that review were granted and this Court reached a determination on the merits, contrary to *Container,* that the tax at issue is unconstitutional, respondent submits that any such decision should have purely prospective application.

ARGUMENT

I.

THIS COURT'S DECISION IN *WARDAIR* MAKES DORMANT COMMERCE CLAUSE ANALYSIS UNNECESSARY. HOWEVER, EVEN IF THAT ANALYSIS WERE TO BE UNDERTAKEN, COLGATE'S CASE HAS BEEN DECIDED BY THIS COURT IN *CONTAINER*.

Colgate petitions from the decision of the California Court of Appeal which, in turn, relies on the California Supreme Court's holding in *Barclays* that Congress has authoritatively consented to the use of worldwide combined reporting and that therefore dormant Commerce Clause analysis is not necessary to a finding of its constitutionality. Colgate argues that such congressional consent cannot be inferred from the evidence presented in

the *Barclays* case (which incidentally is the same evidence presented in this case).[3]

The California Supreme Court's decision in *Barclays* rested on the authority of this Court's holding in *Wardair* that no dormant Commerce Clause analysis need be undertaken when Congress has authoritatively assented to the tax in question, and that such assent may be understood from the implication of congressional actions. Colgate, however, argues that the California Supreme Court misapplied *Wardair,* and that its petition should be granted in order that this Court can address this misapprehension. *Colgate* is not a case in which this issue should be decided. Even if congressional assent to the tax method in question could not be inferred from the evidence, the resulting application of a dormant Commerce Clause analysis would defeat Colgate's claims, because this Court has already undertaken that exercise in *Container,* and has already sustained the constitutionality of the tax method with respect to a U.S.-based multinational business.

Colgate's argument that the California Court of Appeal's *Colgate* decision misapplies *Wardair* relies on the fact that this Court engaged in dormant Commerce Clause analysis in *Container* with virtually the same evidence of Congressional action or inaction before it. However, Colgate neglects to recognize two key factors: (1) this Court's *Container* decision, which considered the evidence in determining that California's practice did not "violate[] a clear federal directive" (463 U.S. at 194,

[3] See Petition, Appendix B, p. 16a.

196-97), did not consider whether the evidence indicated that Congress had *permitted* the use of worldwide combined reporting; (2) in *Container*, California's application of a dormant Commerce Clause analysis to a domestic parent multinational business resulted in a holding that worldwide combined reporting is constitutional. This Court should not accept a case in which the outcome is a foregone conclusion regardless of the method of analysis.

II.

COLGATE DOES NOT AND CANNOT RAISE THE SAME ISSUES AS *BARCLAYS*, AND ITS EQUAL TREATMENT ARGUMENT IS PREMATURE

At page 11 of its petition, Colgate asserts that "The issues raised by the Petition in *Barclays* – issues concerning the constitutionality of worldwide combined reporting under the Commerce Clause and the criteria for determining whether Congress has consented to state action under the Commerce Clause – are the issues that lie at the heart of Colgate's petition. . . . Both the petition in *Barclays* and this petition raise *exactly* the same issue regarding whether Congress has consented to California's use of worldwide combined reporting." A more correct statement would be that both petitions raise the issue of whether under this Court's most recent Commerce Clause jurisprudence, dormant Commerce Clause analysis is necessary. However, as to the dormant Commerce Clause, the issue raised in *Barclays* is the issue reserved in *Container*, the constitutionality of the application of worldwide combined reporting to a *foreign*-based business. In *Container*, this Court has addressed the dormant

Commerce Clause issues which could arise in Colgate's case, in *exactly* the context in which they are raised by the petitioner, a domestic-based business. Colgate has given no convincing reason why *Container* should be reconsidered.

Colgate's argument that U.S. parent groups must be treated the same as foreign parent groups is premature. It is a well-settled principle that this Court will not consider constitutional issues that are not ripe for determination. (*Regional Rail Reorganization Act Cases*, 419 U.S. 102, 138 (1974).) Colgate cites no current final decision or other circumstance which leads to unequal treatment of the two groups. The decision of the California Court of Appeal which is the subject of this petition for *certiorari* is based upon and consistent with this Court's holding in *Container* and with the California Supreme Court's decision in the *Barclays* case. Under these circumstances worldwide combined reporting is applied equally to both domestic and foreign-based unitary businesses. There is equal treatment and no basis for consideration of this issue.

The California Court of Appeal in its first opinion (it had no reason to reach this issue in its second opinion) summarized and addressed Colgate's contentions on equal treatment as follows:

> " . . . on constitutional grounds involving equal protection and the Commerce Clause, Colgate also argues that foreign-parent groups and their domestic-parent counterparts must be treated identically for tax purposes. We are not aware of any final decision holding that state application

of the worldwide unitary tax method to foreign parent groups is unconstitutional under the foreign Commerce Clause. Until such decision, this issue of equality is premature. There is a well-settled principle that courts do not consider constitutional issues that are not ripe for determination. We adhere to that principle in this case and do not express any views on this issue. *We do note that this issue was not litigated below in any meaningful fashion, was not part of the trial court's decision, and consequently has not been briefed adequately here.*" (Petition, Appendix E, p. 66a, fn. 12, emphasis added.)

What Colgate requests is that this Court should conclude in *this* case (involving a domestic parent) that the application of the worldwide unitary method to *foreign*-based groups violates the Commerce Clause and, if this is so, that "application of the tax scheme to domestic-based multinational groups such as Colgate cannot withstand constitutional scrutiny." This case, however, is manifestly not the case in which the constitutionality of worldwide combined reporting as applied to a *foreign*-based parent should be decided. The analysis of the Court of Appeal was correct. Colgate's argument is unpersuasive. Unless or until there is a final decision or some other circumstance by which foreign-based multinational corporations are exempted from the operation of the tax, no discrimination exists with respect to domestic corporations. Colgate's equal treatment issue is not properly before this Court now any more than it was before this Court in *Container*.

III.

THIS COURT'S DECISION IN *CONTAINER* IS CONTROLLING. COLGATE PRESENTS NO NEW ISSUE OR SIGNIFICANT CHANGE OF CIRCUMSTANCE.

Colgate asserts that *Container* may be distinguished or ignored because this Court at the time of the *Container* decision in 1983 did not have before it a clear statement of federal policy from the Executive Branch. Colgate mistakenly attributes to *Container* the proposition that the result in that case would have been different as a matter of law had there been a clear statement from the Executive Branch of a federal policy against the use of the worldwide unitary method involving domestic parent corporations.

In *Container* this Court took note that the Solicitor General did not submit an amicus curiae brief in *Container*, and that the *amicus curiae* brief of the Solicitor General in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co., appeal dismissed*, 464 U.S. 1013 (1983), did not necessarily apply to the *Container* case. (463 U.S. 195-196, fn.33.) However, nothing in *Container* suggests it would have been decided differently had the Solicitor General filed an *amicus curiae* brief. On the contrary, this Court stated in no uncertain terms that " 'The lack of such a submission *is by no means dispositive.*' " (*Container, supra*, 463 U.S. at 195-196, emphasis added.) Moreover, this Court surely never intended to resolve the "one voice" Commerce Clause issue by looking solely to the position of the Executive Branch. Instead, this Court declared that the nuances of the foreign policy of the United States are much more the province of the Executive Branch and Congress than that of the Court. (*Container*, 463 U.S. at

196.) In *Wardair*, this Court entirely dismissed the arguments of the *amicus* brief of the Executive Branch and looked solely to the manifestations of congressional intent in deciding the Commerce Clause issue. (*Id.*, 477 U.S. at 9.) A similar approach was taken in *Itel*, wherein this Court relied on the congressional manifestation of intent to permit the tax, and noted with respect to the U.S. *amicus* brief filed in that case only that the Court found "no reason to disagree with the United States' submission."[4] (*Id.*, 113 S.Ct. at 1105.)

Colgate states that the "missing evidence which was crucial in *Container* has now been supplied by the federal government." (Petition, p. 22.) However, the California Court of Appeal reviewed this "evidence" and found that it did *not* constitute a clear federal directive for purposes of this domestic parent case. As the California Court of Appeal noted in its first opinion (Petition, Appendix E), the Executive Branch was twice explicitly notified about this case, and this case could not have provided a more appropriate context for the executive branch to express its views regarding the application of the unitary method to domestic-parent groups with foreign subsidiaries. "Nevertheless the executive branch here, as in *Container*, has chosen to remain silent." (Petition, Appendix E, p. 56a; see also discussion, pp. 49a-63a.)

---

[4] See also the dissent of Justice Blackmun wherein he states that "consistent with the separation of powers [the *amicus* brief] may not be given any weight beyond the power to persuade," and further notes: "The power to regulate foreign commerce is textually delegated to Congress alone" citing article I, section 8, clause 3 of the United States Constitution. (*Id.*, at 113 S.Ct. 1110.)

IV.

IF COLGATE'S PETITION WERE GRANTED AND COLGATE WERE TO PREVAIL, RELIEF SHOULD BE GRANTED PROSPECTIVELY ONLY.

On June 18, 1993, this Court announced in *Harper* v. *Virginia Dept. of Taxation*, 91-794, ___ U.S. ___, 61 U.S.L.W. 4664, 4666-4667 (1993), "when this Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule." In *Harper*, this Court relied on the majority consensus in *James B. Beam Distilling Co.* v. *Georgia*, 501 U.S. ___, 111 S.Ct. 2439 (1991), in holding that "when this Court does not 'reserve the question whether its holding should be applied to the parties before it' . . . its rule should apply retroactively to the litigants then before the Court." (61 U.S.L.W. at 4667.)

Should this Court grant Colgate's petition, and should Colgate prevail on the constitutional issues, the newly announced rule should not be applied to Colgate's claims in this case but should apply prospectively only. Colgate differs in no pertinent respect from the taxpayer in *Container*. In *Container*, the identical law challenged by the petitioner as applied to an identically situated domestic-based multinational business was declared constitutional in the face of identical Commerce Clause arguments. Overruling of that decision in the circumstances of this case would clearly constitute a new and unanticipated principle of law with severe fiscal impact on the State of California if applied retroactively.

In such an event, this Court should apply its own test, announced in *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 at 106-107 (1971), as follows:

> "First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, see, *e.g., Hanover Shoe v. United Shoe Machinery Corp.*, [392 U.S. 481], at 496 [(1968)], or by deciding an issue of first impression whose resolution was not clearly foreshadowed, see, *e.g., Allen v. State Board of Elections*, [393 U.S. 544], at 572 [(1969)]. Second, it has been stressed that 'we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation.' *Linkletter v. Walker*, [381 U.S. 618], at 629 [(1965)]. Finally, we have weighed the inequity imposed by retroactive application, for '[w]here a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the "injustice or hardship" by a holding of nonretroactivity.' *Cipriano v. City of Houma* [395 U.S. 701], at 706 [(1969)]."

Under *Chevron Oil Co.* v. *Huson*, if this case were to be decided on its merits to conclude, contrary to *Container*, that the tax is unconstitutional, then this Court should either reserve the issue of relief to the petitioner or hold that any new rule would have application prospectively

only.[5] Otherwise, under *Harper*, the rule will apply retroactively to all domestic multinationals which have done business in the State of California and which have met procedural requirements for tax relief. This could result in a revenue loss on the order of $3 billion dollars, solely on the basis of Executive Branch statements of aspiration which (1) under existing nondormant Commerce Clause precedents cannot assume the "one voice" function which the Constitution assigns to actions of Congress and (2) did not even exist at the time of the tax years in question. Respondent contends that in view of *Container's* clear past precedent on the issue, the resulting hardship to the State of California, and the equities of the situation, any decision for Colgate in this case must be applied on a purely prospective basis.[6]

---

[5] As noted by Justice O'Connor in her dissent at 61 U.S.L.W., pp. 4671-4672, the *Harper* holding does not preclude purely prospective applications by this Court.

[6] In 1986, California passed legislation permitting corporations to elect, beginning in 1988, to calculate their income attributable to their California activities on a domestic, or water's edge, basis. (See Petition, Appendix B, p. 5a, fn. 4.) As a result the impact of the tax has been largely abated, and the lasting significance of any issues raised has greatly been reduced.

CONCLUSION

The questions presented in Colgate's petition have already been answered by this Court in its decisions in *Container, Wardair,* and *Itel.* Colgate cannot ride into this Court on the coattails of the *Barclays* petitioner. The petition for a writ of certiorari should be denied.

Dated: July 16, 1993.

Respectfully submitted,

DANIEL E. LUNGREN
Attorney General of the
State of California

TIMOTHY G. LADDISH
Assistant Attorney General

LAWRENCE K. KEETHE
Supervising Deputy Attorney
General

CLAUDIA K. LAND
Supervising Tax Counsel
Franchise Tax Board

JOHN D. SCHELL
Deputy Attorney General
(Counsel of Record)

Attorneys for Respondent

(5)

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PETITIONER'S REPLY BRIEF

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

Counsel for Petitioner

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-1839

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of The State of California,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

---

PETITIONER'S REPLY BRIEF

Respondent's Brief in Opposition ("Opp.") does not seriously contest the significance of the issues that Colgate-Palmolive Company ("Colgate") has raised in its petition for certiorari. Instead, Respondent claims that "those issues, to the extent that they are raised" (Opp. at 2), fall within the exclusive purview of the *Barclays* case which is currently pending before this Court. According to Respondent, these same issues, when raised by Colgate, do not warrant this Court's consideration because, allegedly, this Court has already addressed those issues in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). In addition, Respondent claims that Colgate raises issues that are not ripe for adjudication. As we demonstrate

below, however, there is no merit to Respondent's suggestion that *Container* disposes of the issues raised by Colgate, nor is there merit to the suggestion that Colgate's petition is premature. Moreover, Respondent has failed to explain how the Court can conscientiously decide the issues raised by *Barclays* without addressing the issues raised by Colgate.

I. UNLIKE *CONTAINER*, THIS CASE RAISES THE ISSUE WHETHER WORLDWIDE COMBINED REPORTING IS CONSTITUTIONAL IN THE CONTEXT OF A CLEAR FEDERAL GOVERNMENT STATEMENT OPPOSING THAT METHOD OF TAXATION

Respondent's contention that the issues raised by Colgate in its petition have already been decided by this Court in *Container* is misguided. In equating this case and *Container*, Respondent has ignored the underlying factual premise that formed the basis of the decision in *Container*. In *Container*, this Court found that it did not have before it a clear statement by the federal government regarding the impact of California's method of taxation on federal foreign policy. *Container*, 463 U.S. at 195 n.33. In the absence of such a statement, this Court was limited to holding that it could not, on its own, invalidate California's tax as unconstitutionally interfering with federal foreign policy. *See Itel Containers Int'l Corp. v. Huddleston*, 113 S. Ct. 1095, 1103 (1993). *See also Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev. and Finance*, 112 S. Ct. 2365, 2372 (1992) (Rehnquist, C.J., dissenting). The evidence lacking in *Container* has now been supplied through numerous letters and statements from the federal government expressing opposition to worldwide combined reporting.[1]

[1] Contrary to the assertions of Respondent (Opp. at 5), it is irrelevant that the federal government's opposition to worldwide combined reporting has been supplied in the form of letters and statements. There is no restriction that requires policy to be expressed in a particular form, and many forms of policy expression have been recognized by this Court as equally valid. *See, e.g., Zschernig v. Miller*, 389 U.S. 429, 437 n.7 (1968); *United States v. Pink*, 315 U.S. 203 (1942).

In short, because there was no clear statement of the position of the Executive Branch in *Container*, *Container* decided a different issue from the one presented here. The issue presented in this case is whether, in the context of a clear statement from the Executive Branch that California's method of tax interferes with United States foreign policy, California's taxing method should be invalidated as a violation of the Commerce Clause.[2] This question, which the Court has never considered, is significant and warrants the Court's plenary review.

II. THE DISCRIMINATION ISSUE RAISED BY COLGATE IS RIPE FOR ADJUDICATION

Respondent claims that the issue of discrimination against U.S.-based multinational groups (but not the other issues) raised by Colgate is not ripe because it depends on resolution of the issue raised by *Barclays*, namely, whether the Commerce Clause bars worldwide combined reporting as applied to foreign-based multinational groups. This Court has previously held that "the question of ripeness turns on 'the fitness of the issues for judicial decision' and 'the hardship to the parties of withholding court consideration.'" *Pac. Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 201 (1983) (citing *Abbott Lab. v. Gardner*, 387 U.S. 136, 149 (1967)). Under this test, Respondent's claim that Colgate has prematurely raised the discrimination issue fails.

When an administrative agency has taken every action possible with respect to a claim in litigation, that claim is un-

[2] Contrary to the assertion of Respondent (Opp. at 3 n.1), the Executive Branch has expressed its opposition to worldwide combined reporting in the context of foreign policy concerns. *See, e.g.*, the Secretary of State's and the U.S. Trade Representative's involvement in Secretary Brady's Letter; *see also* foreign policy documents attached to Secretary Brady's Letter.

doubtedly "ripe." *Abbott*, 387 U.S. at 149. Here, there has been full administrative agency consideration and denial of Colgate's claims for refund raising the Commerce Clause issues. No further action by Respondent on these claims is even possible. Moreover, all of the facts and arguments necessary to resolve the issue are in the record in this case. The issue is therefore clearly fit to be adjudicated by this Court. Moreover, if this Court refuses to entertain the discrimination issue until a final decision in *Barclays*, Colgate will never be able to litigate the issue and recover the amounts unconstitutionally paid to the state. A final decision in this case will resolve the claims for refund and the doctrine of *res judicata* will prevent Colgate from reopening this case. Colgate's claims here cannot be saved and litigated later; they will never be any more ripe than they are today. The hardship requirement of the *Abbott* test is therefore also met in this case.

The rationale behind the ripeness doctrine is to "prevent the courts.... from entangling themselves in abstract disagreements over administrative policies, and also to protect the agencies from judicial interference until an administrative decision has been formalized and its effects felt in a concrete way...." *Abbott*, 387 U.S. at 148–49. Colgate has felt the effects of the administrative decision in this case in a concrete way since there can be nothing abstract about the denial of claims for refund. Moreover, since Colgate can have no remedy beyond this lawsuit for the taxes presently at issue, refusal to entertain the discrimination issue will cause irreparable injury. The discrimination issue is ripe for review by this Court.

Although incorrectly labeled as a question of ripeness, it appears that Respondent's true contention is that Colgate should not be able to pursue the discrimination issue until a final decision has been issued in *Barclays*. This is incorrect. All of the facts and arguments relevant to deciding the constitutionality of worldwide combined reporting as applied to a foreign-parent multinational are embraced in the briefs and

records of this instant case.[3] The Court therefore could, if it wished, decide in this case that application of worldwide combined reporting to foreign-parent companies violates the Commerce Clause, and, under the principle of equal treatment for all forms of foreign commerce, consider whether its application to Colgate is prohibited. Indeed, this Court has previously found it necessary to consider the constitutional claims of a third party not before the Court in order to decide the rights of the litigants. *See, e.g., Orr v. Orr*, 440 U.S. 268 (1979); *Barrows v. Jackson*, 346 U.S. 249 (1953).

Significantly, Respondent has not attempted to argue that the substantive issue of whether the Commerce Clause requires domestic-based multinationals engaged in foreign commerce to be treated the same as foreign-based multinationals engaged in foreign commerce is not worthy of this Court's review. Clearly the issue is of national and international significance and should be considered by this Court in the context of this case.

III. *ITEL* DOES NOT ENDORSE RESPONDENT'S VIEW THAT CONGRESSIONAL CONSENT TO STATE ACTION UNDER THE COMMERCE CLAUSE CAN BE INFERRED FROM CONGRESSIONAL SILENCE

Relying on Justice Blackmun's solitary dissent in *Itel*, Respondent claims that this Court has adopted the state court's view that Congress's consent to state laws precluding dormant Commerce Clause scrutiny may be found in "congressional silence." Opp. at 4. The suggestion is preposterous. There was no finding of explicit congressional consent to the state tax at issue in *Itel*, and the Court therefore properly engaged in dormant Commerce Clause analysis in the course of adjudicating the levy's validity. *Itel*, 113 S. Ct. at 1103-05. Indeed, *Itel* strongly reinforces Colgate's view that dormant

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[3] Indeed, the record in *Barclays* is part of the record in this case. *See, e.g., Exhibit 13* (specific findings of facts from the decision in *Barclays*).

Commerce Clause analysis may not be applied "in such a way as to *reverse* the policy that the Federal Government has elected to follow." *Id.* at 1105 (quoting *Wardair Canada Inc. v. Florida Dep't of Rev.*, 477 U.S. 1, 12 (1986)) (emphasis in original).[4]

IV. IF COLGATE PREVAILS IN THIS CASE, RELIEF MUST BE GRANTED ON A RETROACTIVE BASIS

Respondent argues that any decision in favor of Colgate in this case should be applied on a prospective only basis. However, the Court should not consider the issue of prospectivity if it grants review because Respondent has failed to raise this issue in a timely fashion. Respondent first raised this issue at oral argument before the California Court of Appeal. Under California law, however, an issue raised for the first time in oral argument is deemed waived. *See, e.g., Kinney v. Vaccari*, 27 Cal. 3d 348, 356 n.6, 612 P.2d 877, 165 Cal. Rptr. 787 (1980); *Chatterjee v. Kizer*, 231 Cal. App. 3d 1348, 1366 n.4, 283 Cal. Rptr. 60 (1991); *Estate of Davis*, 38 Cal. App. 2d 579, 587, 101 P.2d 761 (1940). Respondent is deemed to have waived this issue, therefore, and cannot raise it at this late stage of the proceedings. In addition, Respondent is contractually bound to apply relief in this case on a retroactive basis. On July 13, 1988, Respondent and Colgate entered into a joint stipulation whereby it was agreed that, if it is determined that Respondent may not combine Colgate with its foreign subsidiaries in a single, worldwide unitary group, Colgate is entitled to refunds. *See* Joint Stipulation, *Colgate-Palmolive Co. v. Franchise Tax Bd.*, No. 319715 (Cal. Super. Ct.) at ¶ 71.

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[4] Inexplicably, Respondent also relies on *Itel* in an effort to deprecate the significance of the Executive Branch's statements as evidence of foreign policy towards worldwide combined reporting. Opp. at 12. In fact, *Itel* relied heavily on the Executive Branch's views in holding that the tax at issue did not frustrate federal foreign policy, observing that "[t]o the extent Itel is arguing that taxes like Tennessee's engender foreign policy problems, the United States disagrees." *Itel*, 113 S. Ct. at 1105.

Even assuming that Respondent may properly raise the prospectivity issue at this juncture, however, the Court's decision must be applied retroactively. In *Harper v. Virginia Dep't of Taxation*, 61 U.S.L.W. 4664 (U.S. June 18, 1993) (No. 91-794), the Court plainly indicated that its decisions must be applied on a retroactive basis in all instances. To be sure, the Court, in *Harper*, was able to rest its decision on the narrower ground that any rule of law applied to the parties before the Court must be applied retroactively to other cases open on direct review. Nevertheless, the Court's references in *Harper* to its lack of "'constitutional authority .... to disregard current law'" (*id.* at 4667, quoting *American Trucking Assns. v. Smith*, 496 U.S. 167, 214 (1987) (Stevens, J., dissenting)) and the fundamental rule of "'retrospective operation' that has governed '[j]udicial decisions'" (*id.* at 4666, quoting *Kuhn v. Fairmont Coal Co.*, 215 U.S. 349, 372 (1910) (Holmes, J., dissenting)), as well as its heavy reliance on *Griffith v. Kentucky*, 479 U.S. 314 (1987), requiring retroactive application of its decisions in criminal cases, leave little doubt that retroactive application of its decisions is constitutionally required in all cases.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Dated: July 30, 1993

Respectfully submitted,

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

Counsel for Petitioner

Supreme Court, U.S.
FILED
OCT 18 1993
OFFICE OF THE CLERK

No. 92-1839

IN THE
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COLGATE-PALMOLIVE COMPANY,
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FRANCHISE TAX BOARD,
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On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

---

SUPPLEMENTAL BRIEF OF PETITIONER

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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RULE 29.1 STATEMENT

The changes to the Rule 29.1 Statement since the filing of Colgate-Palmolive Company's petition for certiorari are listed in the Appendix to this supplemental brief at App. B at 3a.*

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* All references to the Appendix in this brief are denominated "App." followed by a unique letter and a page reference.

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SUPPLEMENTAL BRIEF OF PETITIONER

INTRODUCTION

Two recent developments bearing on this case have precipitated the filing of this supplemental brief by petitioner Colgate-Palmolive Company (hereafter "Colgate") pursuant to Rule 15.7. First, on October 6, 1993, the Governor of California signed legislation enacted a month earlier modifying California's approach to taxing the income of a multinational group of corporations. Second, on October 7, 1993, the Solicitor General filed an amicus brief in *Barclays Bank PLC v. Franchise Tax Bd.*, No. 92-1384—a case closely related to this one—recommending that the Court deny certiorari in *Barclays* on the ground that the recent California legislation obviated the necessity of Supreme Court review.

As we demonstrate below, neither the recent California legislation nor the views of the Solicitor General expressed in *Barclays* diminish the need for this Court to address the issues of profound national and international significance raised by this case. Even assuming that the recent California legislation renders California's tax scheme constitutionally unobjectionable for future years, it leaves undisturbed billions of dollars of tax liabilities for hundreds of taxpayers who are being compelled to report their income on a worldwide combined basis. *See infra* pp. 3-5. In any event, the purported cure for the ills of California's taxing regime is more apparent than real. *See infra* pp. 5-7. Furthermore, rather than providing any sound basis for denying certiorari in *Barclays* (and, by inference, in this case as well), the Solicitor General's brief strongly reinforces the case for granting certiorari.

1. *The recent California legislation.* For tax years beginning on or after January 1, 1994, California Senate Bill 671 (Oct. 6, 1993) modifies the state's treatment of a multinational group of corporations for franchise tax purposes in three principal respects. First, the legislation removes the fee that corporations were required to pay under preexisting law if they wished to limit combined reporting of their income to a "water's-edge" group, *id.* §§ 24, 26, *i.e.*, to certain domestic corporations and to foreign corporations conducting substantial activity in the United States. *See* Cal. Rev. & Tax. Code § 25110(a) (West 1992).[1] Second, the legislation removes the authority the Franchise Tax Board possessed under certain circumstances to disregard a corporation's water's-edge election and to require it to file on a worldwide combined basis. Cal. S.B. 671, §§ 16, 23. Instead, additional penalties and record retention requirements apply to all corporate taxpayers, not just those making the election. *Id.* § 16. Third, the legislation eliminates the Domestic Disclosure Spreadsheet, which corporations making a water's-edge election were required to file under pre-existing law, and requires instead that certain large corporations file a list of 20-percent-or-more-owned affiliates. *Id.* § 13.

[1] California originally enacted this legislation in 1986 to take effect on January 1, 1988. The legislation permits a corporate taxpayer engaged in a worldwide unitary business to compute its California franchise tax liability generally on the basis of its United States, as opposed to its worldwide, operations.

2. *The Solicitor General's amicus brief.* The Solicitor General's amicus brief recognizes that

> [t]he United States has long taken the position that California's application of the worldwide combined reporting method to corporations doing business in California that have foreign parents or foreign affiliates is inconsistent with the "separate accounting" or "arm's length" method under federal law and under established international practice.

S.G. Br. at 4.[2] The Solicitor General further observes that the United States has expressed its concern that "state use of worldwide combined reporting was 'at odds with the position of the United States and has become a source of conflict with foreign states.'" *Id.* (quoting Pet. App. in *Barclays* at H44). Finally, the Solicitor General acknowledges, for reasons set forth in his amicus brief filed at an earlier stage of the *Barclays* case, that "the analysis and holdings of the California Supreme Court are subject to serious question." *Id.* at 8. The Solicitor General nevertheless concludes that the recent California legislation has rendered the question of the constitutionality of worldwide combined reporting uncertworthy on the ground that the case "lacks substantial recurring importance." *Id.* at 10.

3. *The continuing significance of the issues raised by Colgate.* With all due respect to the views of the Solicitor General, we believe that his judgment as to the continuing importance of the issues raised in *Barclays*, and by Colgate

[2] All references to the Solicitor General's brief in this case are denominated "S.G. Br." followed by a page reference.

here, is misguided. In fact, the issues raised in these cases are of enormous continuing significance and, as such, warrant this Court's review.

First, the constitutionality of worldwide combined reporting raised in this case and in *Barclays* is an issue that has fueled widespread disputes between taxpayers and the State of California as illustrated by the multitude of cases currently pending in state courts and administrative tribunals. The amount of taxes at stake in these controversies is enormous. Approximately $1.2 billion in refund claims and $1.9 billion in assessments rest upon the outcome of this case alone, with an additional $500 million in refunds and $350 million in assessments resting upon the outcome of *Barclays*. *See* Report, Senate Revenue & Taxation Committee, S.B. 671 (Alquist), 1993-94 Reg. Sess., August 16, 1993.

Significantly, the Solicitor General recognizes that California's method of taxation, even after the changes in the law in 1986, is fundamentally inconsistent with federal foreign policy [3] and continues to be an irritant in relations with foreign governments. *See* S.G. Br. at 9. In fact, the Solicitor General adopts the analysis set forth in a brief filed by the United States as *amicus curiae* in *Barclays* at an earlier stage in this case. *See* S.G. Br. at 8. That brief took the position that California's method significantly interfered with federal foreign policy despite the fact that a water's-edge election was in place at that time. *Am.* U.S. Br. *Barclays*, No. 92-212, cited in S.G. Br. at 8. By implication, because that method of taxation continues through January 1, 1994, the Solicitor General concurs that California will be imposing a tax in violation of the Commerce Clause at least until that date. The recently enacted legislation does nothing to cure the continuing

[3] The importance of the worldwide combined reporting issue to the federal government, even after the 1986 California legislation, is illustrated by the highly unusual action of the U.S. in filing amicus briefs, subsequent to 1986, in California *state* courts in support of *Barclays*.

Commerce Clause violations as California, for years to come, audits multinational groups to assess and collect a tax computed in a way that the Solicitor General agrees violates the Commerce Clause.

Second, neither the recently enacted California legislation nor the Solicitor General even purports to address the due process concerns presented to this Court by the petitioner in *Barclays*. Indeed, the Solicitor General explicitly limits his comments to issues relevant to the Commerce Clause. *See* S.G. Br. at (i). By failing to address taxpayers' due process concerns, California's new legislative scheme, presented to this Court as a purported cure for the state's current unconstitutional taxing scheme, is incomplete. Foreign-based multinational taxpayers that do not elect to use the water's-edge option will continue to challenge worldwide combined reporting on the basis of the discriminatory compliance burdens imposed by that taxing scheme, and domestic-based taxpayers will continue to assert their right to equal treatment under the Commerce Clause. The Solicitor General's confidence that the issues presented in *Barclays* and this case "lack[] substantial recurring importance" (S.G. Br. at 10) therefore appears to be, at best, optimistic.[4]

In view of the large number of taxpayers that are currently disputing California's use of the worldwide combined reporting method of taxation and the significant amount of tax dollars involved, the continuing practical importance of this controversy and the need for this Court's review are self-evident.

4. *The failure of the recent California legislation to eliminate the unconstitutional burdens imposed on Col-*

[4] In addition, the issue of the constitutionality of worldwide combined reporting continues to have importance to other states' taxing systems. Even now, the State of Alaska imposes worldwide combined reporting, without a water's-edge election, on certain companies engaged in the production or transportation of oil and gas. *See* Alaska Stat. § 43-20-073 (1992).

gate. The Solicitor General is clearly in agreement with Colgate that California's current method of taxation [5] is a "source of conflict" with foreign nations and as such is constitutionally suspect. *See* S.G. Br. at 4, 8, 10. However, despite agreeing with Colgate that the "analysis and holdings" of the California Supreme Court's decisions below "are subject to serious question" (S.G. Br. at 8), the Solicitor General expresses the opinion that the new legislation enacted in California obviates the need for this Court's review of the issues raised in this case. This opinion appears to be based largely on the mistaken premise that corporate taxpayers "now have an unburdened right to be taxed on an 'arm's length' basis." S.G. Br. at 9.[6]

As discussed above, *see supra* pp. 2-3, the new legislation, due to come into effect in California on January 1, 1994, modifies the existing water's-edge legislation enacted by California in 1986. Although the new legislation removes some of the obstacles to filing on a water's-edge basis (for example, the fee, the Domestic Disclosure Spreadsheet, and the ability of the Franchise Tax Board to disregard a taxpayer's election), many of the restrictions to filing on a water's-edge basis remain. For example, the new legislation continues to require that certain foreign corporations be swept into the water's-edge group, including any Canadian or Mexican corporations

[5] The new legislation signed by the Governor on October 6, 1993, does not come into effect until January 1, 1994.

[6] The Solicitor General acknowledges that any view regarding whether the new California legislation remedies the past foreign policy interference is no more than speculation. His brief recognizes that issues "might hereafter arise in connection with enforcement of the State's new legislation." S.G. Br. at 10. The fact that the record in *Barclays*, or *Colgate*, is inadequate to address issues arising under the new legislation has no bearing on the underlying truth that the serious foreign policy and Commerce Clause concerns raised in *Barclays* and *Colgate* are not deprived of future significance by the changes in California law.

eligible for inclusion in the federal consolidated return [7] and any foreign corporation if 20 percent or more of its average apportionment factors are within the U.S. There is still, therefore, much potential for aggravating our foreign trading partners.

Indeed, perhaps the most telling evidence that the new legislation does not present "an unburdened right to be taxed on an 'arm's length' basis" is the reaction of foreign nations themselves. In an official Demarche, the Member States of the European Community and the Commission of the European Communities have notified the U.S. government that they "do not consider that the unitary tax problem is solved." *See* Demarche from the Member States of the European Community and the Commission of the European Communities, reproduced in full in App. A. Rather, the Demarche states that "[a] complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state" (*see* App. A at 2a) and urges the government to support *Barclays*. Clearly, California's proposed legislative solution to the problem of worldwide combined reporting will continue to cause consternation among our foreign trading partners, as the current system has done for the past twenty years. The seriousness of the international ramifications surrounding these issues makes this case worthy of this Court's review.

[7] For example, Colgate itself would be forced to include its Mexican subsidiary within any water's-edge return that it filed or to challenge that condition as a violation of the Commerce Clause.

CONCLUSION

The only constitutionally acceptable result in this case is an unfettered right to use the water's-edge method of taxation. Taxpayers currently do not have that right, nor is that right available under the new legislation. Moreover, even assuming that the Solicitor General is correct and that the new legislation does bestow an unburdened right to use a constitutionally acceptable taxing scheme, this Court should not disregard the ongoing practical importance of the issues raised by the taxpayer in this case and in *Barclays*, which demand this Court's plenary review.

Respectfully submitted,

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

Dated: October 18, 1993

APPENDICES

APPENDIX A

EMBASSY OF BELGIUM

3320 Garfield Street, N.W.
Washington, D.C. 20065

Washington, September 23, 1993

The Honorable Warren Christopher
Secretary of State
Washington, D.C. 20520

Dear Mr. Secretary:

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

Juan Cassiers
Ambassador of Belgium
DC-Presidency

Andreas van Agt
Ambassador of the
Delegation of the
Commission of the
European Communities

UNITARY TAXATION

1. The Member States of the European Community and the European Commission have the honour to refer to their note of 26 March 1993 in which they expressed their strong opposition to worldwide unitary taxation and urged the United States Government to support the Barclays petition for certiorari to the United States Supreme Court. The Member States, together with eight other major trading partners of the United States, subsequently supported the Barclays petition in an amicus curiae brief dated 22 April 1993.

2. The Member States and the European Commission note that the State of California has since passed legislation to modify its unitary tax law. While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

3. The Member States and the European Commission therefore continue strongly to urge the United States Government to support the Barclays petition for certiorari to the United States Supreme Court.

APPENDIX B

RULE 29.1 LIST

The change to the list of Colgate's less than 100 percent owned subsidiaries since the filing of the petition for certiorari is as follows:

Subsidiary	*Ownership Interest*
Colgate Palmolive (India) Ltd.	51.00%

MOTION FILED
JUL 19 1993

Supreme Court, U.S.
FILED
JUL 19 1993
OFFICE OF THE CLERK

No. 92-1839

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On a Petition for a Writ of Certiorari to the Court of Appeal of the State of California In and For the Third Appellate District

---

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE ON PETITION FOR A WRIT OF CERTIORARI

TIMOTHY J. MCCORMALLY
Counsel of Record
MARY L. FAHEY
TAX EXECUTIVES INSTITUTE, INC.
1001 Pennsylvania Avenue, N.W.
Suite 320
Washington, D.C. 20004-2505
(202) 638-5601
Counsel for Amicus Curiae
Tax Executives Institute, Inc.

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE ON BEHALF OF TAX EXECUTIVES INSTITUTE, INC. ON PETITION FOR A WRIT OF CERTIORARI

To the Honorable Chief Justice of the United States and the Associate Chief Justices of the Supreme Court of the United States:

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully moves this Court for leave to file the accompanying brief as *amicus curiae* in support of the Petition for a Writ of Certiorari.

Tax Executives Institute has requested the written consent of all parties to the filing of the accompanying brief. Petitioner Colgate-Palmolive Company has consented to the filing of the brief, but Respondent Franchise Tax Board has refused to consent.[1]

1. Tax Executives Institute, Inc. (hereinafter "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 4,800 members who represent more than 2,400 of the leading corporations in the United States and Canada, nearly all of which are engaged in interstate or foreign commerce. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the Nation, to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and to vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

2. The members of the Institute represent a cross-section of the business community in North America, including foreign-based corporate groups and U.S.-based groups engaged in foreign commerce, and have a significant interest in the effect of worldwide combined reporting on multinational corporations.

3. The issue presented in this case is the constitutionality of the worldwide combined reporting method of taxation as mandatorily applied to a U.S.-based multinational group of corporations. This case is closely related to *Barclays Bank PLC v. Franchise Tax Board*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384), which concerns the application of California's system of taxation to a foreign-based multinational corporation. Both cases raise fundamental questions concerning the application of the Commerce Clause of the Constitution to multijurisdictional businesses.

a. TEI is concerned that a taxpayer-favorable decision in the *Barclays* case, coupled with the Court's not granting a writ in this case, may create disparities between the treatment of U.S.- and foreign-based multinational corporations. Specifically, many of the companies represented by the Institute's membership will be directly affected by the discriminatory taxing scheme that may result if the Court finds worldwide combined reporting to contravene the Commerce Clause as applied to foreign-based taxpayers but is silent on the propriety of the method's application to U.S.-based taxpayers. *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 203 (1983) (Powell, J., with Burger, C.J., and O'Connor, J., dissenting) (invalidating worldwide combined reporting as applied only to foreign-based groups would be "unacceptable" because "[i]t would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation").

b. Moreover, if the Court declines to hear *Barclays* or sustains the constitutional vitality of worldwide combined reporting as it applies to foreign-based companies, the Institute's members whose companies operate in California may find themselves the innocent victims of retaliation by foreign taxing jurisdictions. For example, the United Kingdom has announced that it will take direct retaliatory measures against U.S.-based multinational groups if the problem of worldwide combined reporting as applied to foreign-based groups is not resolved by the end of the year. *See Unitary Taxes: Subsidiaries of U.S. Firms Warned by U.K. of Possible Unitary Tax Retaliation*, BNA Daily Tax Rep., No. 122, June 28, 1993, at G-5 (British government has sent letters to 4,000 U.K. subsidiaries of U.S. firms with operations in California,

---

[1] The consent of the Petitioner has been filed with the Clerk of the Court.

warning the companies that they could be affected by any U.K. retaliatory action). Such a result threatens to vitiate the core value of free trade that emanates from the Commerce Clause. *See Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Finance,* 112 S. Ct. 2365, 2370 (1992) (the Foreign Commerce Clause protects foreign and domestic firms alike because a State's interference with "foreign commerce may create problems, such as the potential for international retaliation, that concern the Nation as a whole").

c. In other words, the Commerce Clause rights of U.S.-based companies are inextricably entwined with the resolution of the *Barclays* case, and hence that case is entwined with the instant one. If the Court declines to hear *Barclays* (or upholds worldwide combined reporting), U.S. companies will face reprisals from foreign governments. On the other hand, if the Court grants review in *Barclays* and vindicates the Commerce Clause rights of foreign-based companies without addressing the application of worldwide combined reporting to U.S.-based groups in the instant case, those U.S. companies may well confront a discriminatory taxing scheme. Neither result would be consonant with the Commerce Clause or with the Court's duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers." *Boston Stock Exch. v. State Tax Comm'n,* 429 U.S. 318, 329 (1977).

4. Because TEI members and the companies by whom they are employed will be materially affected by any decision affecting the Commerce Clause rights of multijurisdictional businesses, the Institute has a special interest in the outcome of this case.

WHEREFORE, it is respectfully requested that Tax Executives Institute's motion for leave to file the accompanying brief *amicus curiae* in support of granting the Petition for a Writ of Certiorari in this case be granted.

Respectfully submitted,

TIMOTHY J. MCCORMALLY
Counsel of Record
MARY L. FAHEY
TAX EXECUTIVES INSTITUTE, INC.
1001 Pennsylvania Avenue, N.W.
Suite 320
Washington, D.C. 20004-2505
(202) 638-5601
Counsel for Amicus Curiae
Tax Executives Institute, Inc.

July 19, 1993

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---

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE ON PETITION FOR A WRIT OF CERTIORARI

INTEREST OF AMICUS CURIAE

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of granting the petition for a writ of certiorari. Tax Executives Institute (hereinafter "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 4,800 members

who represent more than 2,400 of the leading corporations in the United States and Canada.

TEI is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the Nation, to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and to vindicating the Commerce Clause and other constitutional rights of all business taxpayers. The members of the Institute represent a cross-section of the business community in North America. The overwhelming majority of the companies represented by our membership are engaged in interstate commerce and a substantial number of them have significant sales or operations overseas. In addition, the Institute's membership includes individuals who are employed by the U.S. affiliates of foreign-based multinational groups. Consequently, the Institute and its members have a direct and substantial interest in the effect of the worldwide combined reporting method of taxation on multijurisdictional corporations.

The issue presented in this case is the constitutionality of the worldwide combined reporting method of taxation as mandatorily applied to a U.S.-based multinational group of corporations. This case is closely related to *Barclays Bank PLC v. Franchise Tax Board*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384), which is also before the Court and which concerns the application of California's system of taxation to a foreign-based multinational corporation. Both cases raise fundamental questions concerning the application of the Commerce Clause of the Constitution to multijurisdictional businesses. TEI is concerned that a taxpayer-favorable decision in *Barclays*, coupled with the Court's *not* granting a writ in this case, may create disparities between the treatment of U.S.- and foreign-based multinational corporations. On the other hand, if the Court declines to strike down worldwide combined reporting as it applies to foreign-based companies, the Institute's members whose companies operate in

California may find themselves the innocent victims of retaliation by foreign taxing jurisdictions.

Because TEI members and the companies by whom they are employed will be materially affected by the Court's decision, the Institute has a special interest in the outcome of this case.

SUMMARY OF ARGUMENT

The issue presented in this case is the constitutionality of the worldwide combined reporting method of taxation as mandatorily applied to a U.S.-based multinational group of corporations. This case is closely related to *Barclays Bank PLC v. Franchise Tax Board*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384), which concerns the application of California's system of taxation to a foreign-based multinational corporation. Both cases raise fundamental questions concerning the application of the Commerce Clause of the Constitution to multijurisdictional businesses.

The Court has already recognized the potential significance of the *Barclays* case by inviting the Solicitor General to submit a brief *amicus curiae* expressing the views of the United States. Because the constitutional issue involved in *Barclays* is also present in the instant case (albeit in a different factual setting), *amicus* TEI urges the Court to link the two cases. Hence, if a writ of certiorari is granted in *Barclays*, a writ should also be issued in the instant case. If this case is not heard, U.S.-based taxpayers may be faced with continued uncertainty at best and a discriminatory taxing scheme at worst.

This Court has unequivocally recognized that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce." *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Finance*, 112 S. Ct. 2365, 2370 (1992). The broader protection—which extends to U.S.-based companies engaged in foreign commerce—owes itself to

the realization that a State's interference with foreign commerce may create problems, including international retaliation. *Id.* Additionally, the Commerce Clause proscribes the granting of a preference to one form of commerce over another. *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977). Thus, discrimination between foreign-based and U.S.-based multinational groups—each engaged in foreign commerce—is wholly inconsistent with the Commerce Clause's free trade purposes.

A writ of certiorari should also issue in the instant case because the potential for retaliation that concerned the Court in *Kraft* is manifest here. The United Kingdom has already enacted legislation to deny refunds on dividends paid by U.K. subsidiaries to certain U.S. multinational corporations. The tax authorities in that country recently announced that direct retaliatory measures will be taken against U.S. multinational groups if the problem of worldwide combined reporting as applied to foreign-based groups is not resolved by the end of 1993. The German government (among others) is considering similar retaliatory action. Such retaliation threatens to vitiate the core value of free trade that emanates from the Commerce Clause and that protects foreign-based and U.S.-based groups alike.

ARGUMENT

I.

This Court now has before it separate petitions for writs of certiorari in two cases involving the constitutional validity of California's system of taxing multijurisdictional businesses that are engaged in foreign commerce. The State of California uses what is known as the worldwide combined reporting method of taxation, under which all the worldwide affiliates of a multinational group of corporations that are engaged in a unitary business are treated as a single enterprise; the unitary group's worldwide income is apportioned between California and the rest of the world based on a three-factor formula of property, payroll, and sales.[1] *Barclays Bank PLC v. Franchise Tax Board*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384), involves the application of the worldwide combined reporting method to a group of foreign and domestic corporations with a foreign parent (a foreign-based multinational group). The instant case, in contrast, involves the mandatory application of worldwide combined reporting to a U.S.-based multinational group—*i.e.*, one whose parent is a domestic corporation.

---

[1] Worldwide combined reporting is substantially different from the arm's-length, or "separate accounting," method that the United States has adopted not only for purposes of the Internal Revenue Code, but also in its income tax treaties with foreign countries. *See* I.R.C. § 482; U.S. Department of the Treasury, *Model Income Tax Treaty of June 16, 1981*, arts. 7(2), 9(2), *reprinted in* 1 Tax Treaties (CCH) ¶ 211 (1993). Under this method—which has gained international acceptance—the members of a multijurisdictional group are viewed as separate from one another, and the income of any particular member of a group is determined on the basis of the internal accounting records of that member; group members are required to report intercompany transactions on an arm's-length basis—that is to say, as if they were dealing with unrelated entities. *See* Organization for Economic Co-operation and Development, *Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital*, arts. 7(2), 9(2) (1992), *reprinted in* 1 Tax Treaties (CCH) ¶ 201 (1993).

The companies represented by *amicus* TEI have no uniform position concerning the propriety or impropriety of the worldwide combined reporting method of taxation. Some companies benefit from the unitary method in terms of their tax liability, whereas others would clearly pay higher taxes if the mandatory use of the method were sustained. No one benefits, however, from the uncertainty that has prevailed in this area since at least 1983—when the Court decided *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983)—and that will continue to obtain in the absence of the Court's resolution of the issues raised by *Barclays* and the instant case. Consequently, the Court should act to discharge its duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

II.

The Court has already recognized the potential significance of the *Barclays* case by inviting the Solicitor General to submit a brief *amicus curiae* expressing the views of the United States. 61 U.S.L.W. 3771 (U.S. May 17, 1993) (No. 92-1384). Because the constitutional issue involved in *Barclays*—whether worldwide combined reporting violates the Commerce Clause of the Constitution—is also present in the instant case (albeit in a different factual setting), *amicus* TEI urges the Court to link the two cases. Hence, if a writ of certiorari is granted in *Barclays*, a writ should also be issued in the instant case. Such an action will help ensure that the constitutional issue will be resolved in a comprehensive, balanced, and consistent manner. If the instant case is not heard, U.S.-based taxpayers may be faced with continued uncertainty at best and a discriminatory taxing scheme at worst.

The similarities between *Barclays* and the instant case are easily stated. Both cases involve the propriety of

California's imposition of the worldwide combined reporting method of taxation. In upholding the California taxing scheme in each case, the California courts relied on the same dubious interpretation of this Court's 1986 decision in *Wardair Canada Inc. v. Florida Dep't of Revenue*, 477 U.S. 1 (1986).[2] Specifically, the courts below distended *Wardair* to transmute congressional silence (or inaction) about worldwide combined reporting into approval of that method of taxation. *Amicus* TEI submits that certiorari should be granted in both cases to prevent the evisceration—by acquiescence—of the Court's dormant Commerce Clause jurisprudence.

Perhaps even more important than the two cases' similarities, however, is their fundamental difference: *Barclays* involves a foreign-based corporate group, whereas the instant case involves a U.S.-based group. Thus, if review is granted in *Barclays* to vindicate the Commerce Clause rights of Barclays and other foreign-based multinational groups, the question presented by the instant case explicitly becomes whether "[t]he condemnation of the worldwide unitary method applies to all instrumentalities of foreign commerce, not just foreign based corporate groups." *Colgate-Palmolive Co. v. Franchise Tax Board*, No. 319715, *reprinted at* App. F, at 90a (Sup. Ct. for

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[2] In the instant case, the California Court of Appeal felt constrained to adopt the analysis of *Wardair* propounded by the California Supreme Court in *Barclays. Colgate-Palmolive Co. v. Franchise Tax Board*, 13 Cal. Rptr. 2d 761, 771 (Cal. App. 3 Dist. 1992), *reprinted at* Appendix B to Colgate-Palmolive's Petition for a Writ of Certiorari (App.), at 18a. *See Barclay's Bank Internat'l Ltd. v. Franchise Tax Board*, 2 Cal. 4th 708, 714 (1992) (*Wardair* "reflects a diminution in the reach of dormant foreign commerce clause analysis in favor of an expanded recognition that, under circumscribed conditions, governmental silence may constitute a ratification of state taxation of foreign commerce, rendering a dormant analysis inapposite"), *on remand*, 14 Cal. Rptr. 2d 537 (Cal. App. 3 Dist. 1992), *petition for cert. filed sub nom. Barclays Bank PLC v. Franchise Tax Board*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384).

the County of Sacramento, April 19, 1989). *Amicus* TEI submits that to pose the question is to answer it: U.S.-based groups are properly accorded no less protection by the Commerce Clause than foreign-based groups. Thus, the Court should grant review in order to confirm that the Constitution requires that the foreign commerce conducted by a U.S.-based multinational group be taxed in the same way as the foreign commerce conducted by a foreign-based multinational group.

III.

The Court has recognized that "the constitutional prohibition against state taxation of *foreign* commerce is broader than the protection afforded to interstate commerce." *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Finance*, 112 S. Ct. 2365, 2370 (1992) (citing *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 445-46 (1979)) (emphasis added).[3] The broader protection —which extends not only to foreign taxpayers but to U.S.-based taxpayers engaged in foreign commerce—owes itself to the realization that a State's interference with "foreign commerce may create problems, such as the potential for international retaliation, that concern the Nation as a whole." *Id.* at 2370.

Additionally, the Court has unequivocally held that the Commerce Clause proscribes the granting of a preference to one form of commerce over another. *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977). Thus, discrimination between foreign-based and U.S.-based multinational groups—each engaged in foreign

[3] Thus, a state tax cannot survive scrutiny under the Foreign Commerce Clause if the tax would "impair federal uniformity in an area where federal uniformity is essential," *Japan Line*, 441 U.S. at 448, or prevent "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Id.* at 451 (quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976)).

commerce—is "wholly inconsistent with the free trade purpose of the Commerce Clause." *See id.* at 336; *Kraft*, 112 S. Ct. at 2370; *accord Container Corp. of America v. Franchise Tax Board, supra*, 463 U.S. at 203 (Powell, J., with Burger, C.J., and O'Connor, J., dissenting) (invalidating worldwide combined reporting as applied only to foreign-based groups would be "unacceptable" because "[i]t would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation").

A writ of certiorari should issue in the instant case because the potential for retaliation that concerned the Court in *Kraft* is manifest here. In 1985, the United Kingdom enacted legislation that would effectively penalize U.S.-based corporate groups for the States' (and Federal Government's) inability to resolve the worldwide combined reporting issue in a satisfactory manner.[4] More recently, tax authorities in the United Kingdom have announced that the government will take direct retaliatory measures against U.S.-based multinational groups if the problem of worldwide combined reporting as applied to foreign-based groups is not resolved by the end of 1993. *See Unitary Taxes: Subsidiaries of U.S. Firms Warned by U.K. of Possible Unitary Tax Retaliation*, BNA Daily Tax Rep., No. 122, June 28, 1993, at G-5 (Inland Revenue issued a press release dated May 13, 1993, and has sent letters to 4,000 U.K. subsidiaries of U.S. firms with operations in California, warning the companies that they could be affected by any U.K. retaliatory action[5]).

[4] Sections 54(1) and (3) of, and schedule 13, paragraph 15 to, the Finance Act of 1985, *reenacted as* sections 812-815 of the U.K. Income and Corporation Taxes Act, 1988, would deny Advance Corporation Tax refunds on dividends paid by U.K. subsidiaries to certain U.S. multinational corporations (those having a qualifying presence in a unitary state such as California).

[5] The press release issued by Inland Revenue (the U.K. tax agency) quotes the Chancellor of the Exchequer, as follows:

Other countries, too, have abjured California's abandonment of "the hitherto prevailing principles for the taxation of international business enterprises" and threatened reprisals against U.S.-based groups. *See Unitary Taxes: Bundestag Calls on German Government to Consider Possible Retaliatory Action*, BNA Daily Tax Rep., No. 133, July 14, 1993, at G-1 (resolution of German Bundestag's Finance Committee calls on German government to consider retaliatory steps if a solution to California worldwide combined reporting controversy cannot be reached by the end of 1993; European Community Tax Commissioner Christiane Scrivener has warned that the European Community may also take retaliatory measures). Such retaliation threatens to vitiate the core value of free trade that emanates from the Commerce Clause and that protects foreign-based and U.S.-based groups alike.

IV.

The Commerce Clause rights of U.S.-based companies are inextricably entwined with the resolution of the *Barclays* case, and hence that case is entwined with the instant one. If the Court declines to hear *Barclays* (or upholds worldwide combined reporting), U.S. companies may face reprisals from foreign governments. In contrast, if the Court grants review in *Barclays* and vindicates the Commerce Clause rights of foreign-based companies without addressing the application of worldwide combined reporting to U.S.-based groups in the instant case, those U.S. companies may well confront a discriminatory taxing

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> [T]he [British] Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year. Meanwhile, I have instructed the Inland Revenue to obtain information from California-based companies in the U.K. on the probable impact of such retaliatory measures.
>
> Press Release of Inland Revenue (May 13, 1993).

scheme. Neither result would be consonant with the policies underlying the Commerce Clause.

To avoid such a result, the Court should act to discharge its duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977). Where the States have overstepped their bounds and impinged upon the rights of taxpayers—be they U.S.-based or foreign-based—it is incumbent upon the Court to intercede in order to restore the constitutional balance—and thereby to vivify the core values underlying the Commerce Clause.

CONCLUSION

For the foregoing reasons, the Court should grant a writ of certiorari in this case.

Respectfully submitted,

TIMOTHY J. MCCORMALLY
Counsel of Record
MARY L. FAHEY
TAX EXECUTIVES INSTITUTE, INC.
1001 Pennsylvania Avenue, N.W.
Suite 320
Washington, D.C. 20004-2505
(202) 638-5601
Counsel for Amicus Curiae
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MOTION FOR LEAVE TO FILE BRIEF AMICI CURIAE AND BRIEF FOR COMMITTEE ON STATE TAXATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICI CURIAE IN SUPPORT OF PETITIONER

ROBERT CORCORAN
Counsel of Record
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-8103

MONA C. ZEIBERG
NATIONAL CHAMBER LITIGATION CENTER, INC.
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

Attorney for Amicus Curiae The Chamber of Commerce of The United States of America

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---

MOTION FOR LEAVE TO FILE BRIEF AMICI CURIAE

The Committee on State Taxation and the Chamber of Commerce of the United States of America (collectively "*amici*") hereby respectfully move for leave to file the attached brief *amicus curiae* in this case. The consent of the attorney for the petitioner has been obtained. The consent of the attorney for respondent was requested but refused.

The interest of *amici* in this case arises from the fact that many of their members are U.S.-based multinational corporations subject to California's taxing method at issue in this case. These members would be directly affected by the discriminatory taxing scheme that would result if this Court found worldwide combined reporting unconstitutional as applied to foreign-based taxpayers but not as applied to U.S.-based taxpayers.

California's use of the worldwide combined reporting method of taxation has been the cause of considerable international controversy. Indeed, the United Kingdom has announced that it will take direct retaliatory measures against U.S.-based multinationals by the end of the year if the problem of worldwide combined reporting as applied to foreign-based multinationals is not resolved. Many of *amici's* members will be directly affected by this retaliation.

Amici are confident that this Court will take the necessary steps to prevent this retaliatory legislation from becoming effective by granting the petition for *certiorari* in the case challenging the constitutionality of worldwide combined reporting as applied to a foreign-based multinational group. *See Barclays Bank Int'l Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 8 Cal. Rptr. 2d 31, 829 P.2d 279 (1992), *on remand*, 11 Cal. App. 4th 1678a (3d Dist. 1992), *petition for cert. filed sub nom. Barclays Bank PLC v. Franchise Tax Bd.*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384). In seeking to resolve this problem, however, *amici* are concerned that its U.S.-based members may become victims of an even greater problem. For if the constitutionality of worldwide combined reporting is reviewed solely in the context of a foreign-parent multinational group, there is a real danger that a discriminatory taxing scheme will be created whereby worldwide combined reporting is declared unconstitutional as applied to a foreign-based group, but not as applied to a U.S.-based group.

Although petitioner Colgate-Palmolive Company raised the issue of the unconstitutionality of the taxing scheme that would result from worldwide combined reporting applying only to U.S.-based multinationals, the complexity of the other issues being raised in this case prevented this argument from being completely developed in the petition for writ of *certiorari*. *Amici* request permission to file a brief that will contain a more detailed discussion on this issue. In particular, on behalf of their members, *amici* wish to stress to this Court the broad-based implications of such a discriminatory taxing scheme both in terms of the damage to competitive balance for U.S.-based businesses and the violation of the free trade principles of the Commerce Clause.

Respectfully submitted,

ROBERT CORCORAN
Counsel of Record
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-8103

MONA C. ZEIBERG
NATIONAL CHAMBER LITIGATION CENTER, INC.
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

Attorney for Amicus Curiae
The Chamber of Commerce
of The United States of America

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

No. 92-1839

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California In and for the Third Appellate District

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BRIEF FOR THE COMMITTEE ON STATE TAXATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICI CURIAE IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*

The *amici curiae* are organizations representing a wide spectrum of U.S. business interests, including both U.S.-based multinational companies and foreign-based multinational companies. The Committee on State Taxation (hereafter "COST") is a non-profit association originally organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. On January 1, 1992, COST was separately incorporated and currently has a membership of over 380 major multistate corporations, engaged in interstate and international business. The Chamber of Commerce of the United States of America

(hereafter the "Chamber") is the largest federation of business companies and associations in the world. With substantial membership in each of the fifty states, the Chamber represents approximately 215,000 businesses and organizations and serves as a major voice of the American business community.

The interest of the *amici* in this case arises from the fact that many of their members are U.S.-based multinational corporations subject to California's taxing method at issue in this case. While the petitioner in this case (hereafter "Colgate") is challenging California's use of the worldwide combined reporting method of taxation on behalf of U.S.-based taxpayers, the petitioner in *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 8 Cal. Rptr. 2d 31, 829 P.2d 279 (1992), *on remand*, 11 Cal. App. 4th 1678a (3d Dist. 1992), *petition for cert. filed sub nom. Barclays Bank PLC v. Franchise Tax Bd.*, 61 U.S.L.W. 3621 (U.S. Feb. 22, 1993) (No. 92-1384), is challenging that same method of taxation on behalf of foreign-based taxpayers. *Amici* filed briefs as *amici curiae* in the *Barclays Bank* case, supporting the petitioner's challenge to California's use of worldwide combined reporting. Because *Barclays Bank* involves only a foreign-based multinational taxpayer, *amici's* U.S.-based multinational members would be directly affected by the discriminatory taxing scheme that would result if this Court found worldwide combined reporting unconstitutional only as applied in *Barclays Bank*.

In addition, each of the *amici* is committed to principles of free trade in both domestic and foreign commerce. In this regard, it is the objective of each of the *amici* to preserve and promote equitable and non-discriminatory state and local taxation of multijurisdictional business entities. *Amici* therefore have a strong interest in ensuring that U.S.-based multinationals are treated the same as foreign-based multinationals in the challenge to California's use of the worldwide combined reporting method

of taxation. *Amici* are concerned that, if U.S.-based taxpayers are not treated the same as foreign-based taxpayers, the competitiveness of U.S. industry and the U.S. economy will be seriously impaired. Moreover, U.S.-based companies will be discouraged from investing abroad, thereby impeding the very principles of free trade that *amici* are committed to protect. *Amici* believe that, if this Court decides to review whether worldwide combined reporting is unconstitutional as applied to foreign-based taxpayers, then the petition for *certiorari* must be similarly granted in this case in order to avoid these undesirable consequences.

The consent of the attorney for the petitioner has been obtained for the filing of this brief. The consent of the attorney for respondent has been requested but refused. A motion for leave to file this brief is attached.

SUMMARY OF THE ARGUMENT

I. It is the "very purpose of the Commerce Clause . . . to create an area of free trade among the several States." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944). In upholding this purpose, the Court has consistently intervened to prevent discriminatory treatment of "protected commerce," whether foreign or domestic. *See Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977); *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev. and Finance*, 112 S. Ct. 2365 (1992). This fundamental precept of Commerce Clause analysis will be violated if this Court finds worldwide combined reporting unconstitutional as applied to foreign-based taxpayers but not as to U.S.-based taxpayers. Such a discriminatory taxing scheme would discourage outbound U.S. investment, thereby impeding the very free flow of trade that the Commerce Clause was designed to protect.

The sensitivity of this Court to discriminatory taxation has been particularly acute in the context of foreign com-

merce. *See Kraft,* 112 S. Ct. at 2370; *see also Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979). This broader protection from discriminatory taxation emanates from the realization that a single state's interference with "foreign commerce may create problems, such as the potential for international retaliation, that concern the Nation as a whole." *Kraft,* 112 S. Ct. at 2370. The discriminatory scheme that would be created if worldwide combined reporting were constitutionally prohibited only as applied to foreign-based taxpayers would affect the United States as a whole, damaging its credibility and standing as a nation committed to free trade and fair dealings in international commerce.

In addition to constitutional consequences, this issue also has serious consequences for the foreign and economic policy of the federal government. The longstanding policy of ensuring a level playing field for U.S.-based businesses in the international marketplace will be jeopardized if the Court grants the petition in *Barclays* but not in this case.

II. The petitioner in this case and the petitioner in *Barclays* raise exactly the same question as to whether Congress can consent to California's use of worldwide combined reporting by remaining silent. Indeed, the five items of inaction found by the California Supreme Court to constitute congressional consent in *Barclays* are exactly the same items of inaction relied on by the court of appeal to find congressional consent in this case. If this case and *Barclays* are not subject to the same ultimate disposition, considerable confusion could be generated over the correct standard with which to analyze congressional consent.

REASONS FOR GRANTING THE PETITION

California's use of the worldwide combined method of taxation has been the cause of considerable international controversy and consternation among our foreign trading

partners. The controversy has led to a real and immediate risk of retaliation against U.S.-based multinationals by the United Kingdom which will have a considerable effect on the flow of capital in world markets and discourage U.S. investment abroad. In addition, the court of appeal decision in this case has challenged the very premise of the free trade purposes underlying the Commerce Clause. By inferring congressional consent from congressional silence, the California court has gutted the protection of foreign commerce offered by the Commerce Clause.

Amici believe that these issues alone warrant review by this Court. However, there is an additional consideration of particular concern to *amici,* which consideration will be the focus of this submission.

In seeking to resolve the problem of the United Kingdom retaliatory legislation that is likely to be directed against U.S.-based multinationals, the *amici* are concerned that this Court may subject *amici's* U.S.-based members to an even greater disadvantage. For if the petition is granted in *Barclays* but not in this case, there is a real danger that a discriminatory taxing scheme will be created whereby worldwide combined reporting is declared unconstitutional as applied to a foreign-based group, but not as applied to a U.S.-based group. Not only does the Commerce Clause prohibit application of worldwide combined reporting to domestic-based taxpayers if its application to foreign-based taxpayers is constitutionally prohibited, but also, such discrimination is directly contrary to a longstanding U.S. economic and foreign policy that has been committed to ensuring a level playing field in the international commercial arena. In addition, this case raises *exactly* the same issues as are raised in *Barclays,* and therefore the ultimate disposition of the two cases must be the same.

I. IMPORTANT PRINCIPLES, BOTH CONSTITUTIONAL AND ECONOMIC, REQUIRE THAT U.S.-BASED TAXPAYERS BE TREATED THE SAME AS FOREIGN-BASED TAXPAYERS.

A. The Commerce Clause Requires That U.S.-Based Taxpayers Engaged In Foreign Commerce Be Treated The Same As Foreign-Based Taxpayers Engaged In Foreign Commerce.

Amici believe that if the petition is granted in *Barclays*, the petition in this case must likewise be granted in order to ensure that U.S.-based taxpayers are not subject to a discriminatory taxing scheme by California. Not only would such a taxing scheme violate the free trade principle that has been fundamental to Commerce Clause jurisprudence, but, in addition, such a tax scheme would disregard "sensitive matters of foreign relations and national sovereignty" recognized by the Court in *Japan Line*, that should be left to the federal government.

At the very heart of the Commerce Clause lies the principle of free trade in both a national and an international context. Indeed, this Court has recognized that "[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States." *McLeod*, 322 U.S. at 330. In upholding this principle, the Court has consistently intervened to prevent discriminatory treatment of "protected" commerce. Therefore, in *Boston Stock Exch.*, this Court struck down a tax statute which preferred one form of interstate commerce over another. In so doing, this Court stated that the "diminution of free competition" that was a result of the discriminatory tax was "wholly inconsistent with the free trade purpose of the Commerce Clause." *Id.* at 336. Similarly, in *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984), the Court struck down a West Virginia gross receipts tax that discriminated against out-of-state manufacturers, stating that "[i]t long has been established that the Commerce Clause of its own force protects free trade among the

States." *Id.* at 642. *See also Kraft*, 112 S. Ct. 2365 (1992), in which the Court struck down an Iowa statute that treated dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries.

If this Court finds worldwide combined reporting unconstitutional as applied to foreign-based but not U.S.-based taxpayers, such discrimination would interfere with the very principles of free trade that the Commerce Clause was designed to protect, directly discouraging U.S.-based businesses from investing abroad, and restricting the free flow of capital in international trade. The Commerce Clause therefore prohibits such discriminatory taxation of foreign commerce conducted through U.S.-based groups in favor of foreign commerce conducted through foreign-based groups.[1]

The prohibition against such a discriminatory taxing scheme has already been recognized by members of the Court. In *Container Corp.*, Justice Powell, joined by Chief Justice Burger and Justice O'Connor, made it clear in his dissent that domestic-parent groups cannot be taxed when the taxation of foreign-parent groups is constitutionally barred. *Container*, 463 U.S. at 202. Indeed, Justice Powell called a taxing scheme that so discriminated "unacceptable" because "[i]t would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation." *Container*, 463 U.S. at 203 (Powell, J., dissenting).

In addition, the sensitivity of this Court to discriminatory taxation has been particularly acute in the context of

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[1] This Court has expressly found that domestic-parent groups with foreign operations are engaged in foreign commerce. *See Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 188-89 (1983) ("[T]he tax here falls . . . on a corporation domiciled and headquartered in the United States. We specifically left open in *Japan Line* the application of that case to 'domestically owned instrumentalities *engaged in foreign commerce*' . . . this case falls clearly within that reservation." (Emphasis added.)).

foreign commerce. This Court has acknowledged that the "constitutional prohibition against state taxation of foreign commerce is broader than the protection offered to interstate commerce." *Kraft*, 112 S. Ct. at 2370. *See also Japan Line*, 441 U.S. at 446 ("When construing Congress' power to 'regulate Commerce with foreign Nations,' a more extensive constitutional inquiry is required"). This broader protection emanates from the realization that a state, acting unilaterally, might invoke international repercussions that affect the entire nation. As the Court has stated, "a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Japan Line*, 441 U.S. at 456. *See also Kraft*, 112 S. Ct. at 2370 ("foreign commerce may create problems, such as the potential for international retaliation, that concern the Nation as a whole"). To be sure, "[i]f it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung v. Freeman*, 92 U.S. 275, 280 (1876).

If worldwide combined reporting is applied only to U.S.-based taxpayers, such discrimination would considerably weaken the credibility and standing of the United States in its dealings with other nations. The United States has consistently held itself out as a champion of free trade and fair dealings in international commerce. Yet it is without doubt that applying worldwide combined reporting only to U.S.-based companies would have a chilling effect on outbound investment and the free flow of commerce. The credibility of the United States federal government would be seriously damaged if it were in the position whereby it was urging removal of trade barriers by other nations at the same time as one of its own states was applying a taxing scheme that so clearly impeded the free flow of commerce in the international arena.

The irony of this situation has already been recognized and commented on by our trading partners. In a letter

to Nicholas Brady, then Secretary of the Treasury from the Right Honourable Mr. Michael Grylls, Member of the British Parliament, dated October 23, 1991, and attached to Petitioner's Opening Brief on the Merits filed in the California Supreme Court on February 24, 1992, Mr. Grylls expressed his opposition to worldwide combined reporting as applied to domestic-based taxpayers. In so doing, Mr. Grylls noted his "concern" as to the effect of worldwide combined reporting on the outbound investments of U.S.-based multinationals and stated that "[m]easures which distort trade flows have been strongly criticised in the current GATT Uruguay round of negotiations, not the least by the United States."

There is a real risk, therefore, that if worldwide combined reporting is constitutionally prohibited only with regard to foreign-based taxpayers, the resulting tax scheme could have implications for the nation as a whole and, as this Court noted in *Japan Line*, "California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." *Japan Line*, 441 U.S. at 453.

B. The Maintenance Of Competitive Balance For U.S.-Based Businesses Has Been A Longstanding Policy Of The Federal Government

Ensuring a level playing field for domestic-based businesses in the international marketplace has been of fundamental importance to this nation's foreign and economic policy. This policy will be directly jeopardized if the Court grants the petition in *Barclays* but not in this case.

The importance to U.S. foreign policy of competitive equality for U.S.-based businesses has been stressed repeatedly by those responsible for conducting U.S. foreign policy. As George Shultz, then Secretary of State, set forth in an official Department of State policy statement:

> The strength of the United States in world affairs, including the achievement of our political and secu-

> rity aims, rests directly upon the foundation of a healthy economy. Particularly important in this regard is our nation's vitality and competitiveness in the international marketplace. Foreign economic and commercial policy is an integral and important element of overall foreign policy.

Policy Statement on Assistance to U.S. Businessmen, Memorandum for All Assistant Secretaries and Bureau Directors, issued May 12, 1987, and *quoted in Congressional Record*, Extension of Remarks, 100th Cong., 1st Sess., Vol. 133, No. 110. Similarly, more recently, a Department of State *Dispatch* reemphasized the federal government's commitment to ensuring competitive equality for American business and outlined a "bill of rights" for American business in the context of the foreign policy carried out by the Department. This includes the right to "[b]e assured that the ground rules for the conduct of international trade are fair and non-discriminatory." Jim Pinkelman, *Department "Gets Down to Business" by Assisting U.S. Firms Promoting American Exports*, U.S. Department of State, *Dispatch*, April 29, 1991, at 306, 306.

The new administration is similarly committed to ensuring a level playing field between domestic-based and foreign-based taxpayers. In his confirmation hearings before the U.S. Senate, Secretary of State Warren Christopher expressed the view of the current administration that "[i]n an era in which economic competition is eclipsing ideological rivalry, it is time for diplomacy that seeks to assure access for U.S. businesses to expanding global markets." Statement at U.S. Senate Confirmation Hearing Before the Senate Foreign Relations Committee on January 13, 1993. To that effect, Secretary of State Christopher has streamlined the Department of State in order "to enhance our capabilities to deal with issues that transcend national boundaries and to improve the international competitiveness of American businesses." *Id. See also* Directive to State Department Employees announcing reorganization dated February 5, 1993, U.S. Department of State, *Dispatch*, February 8, 1993.

Permitting worldwide combined reporting to be applied to domestic-based taxpayers when its application to foreign-based taxpayers is barred would fundamentally undercut the foreign and economic policy of the United States government. This cannot be allowed to happen. If the petition for *certiorari* is granted in *Barclays, amici* urge this Court to grant the petition in this case.

II. IN ORDER TO AVOID DISPARATE TREATMENT OF FOREIGN-BASED AND DOMESTIC-BASED MULTI-NATIONALS, THE ISSUES THAT ARE RAISED BOTH IN THIS CASE AND IN *BARCLAYS* MUST BE SUBJECT TO THE SAME ULTIMATE DISPOSITION.

Like Colgate, the petitioner in *Barclays* is challenging the constitutionality of California's use of the worldwide combined reporting method of taxation. Specifically, the petitioner in *Barclays* has raised the question whether Congress can consent to California's taxing method by remaining silent. If such silence does not constitute consent, *Barclays* has asked this Court whether worldwide combined reporting interferes with the federal government's ability to conduct foreign policy in violation of the dormant Commerce Clause of the U.S. Constitution.

As can be seen in Colgate's petition, these are the very issues raised by this case. Indeed, the question as to whether Congress can consent to a state law by remaining silent and thereby remove that law from the scrutiny of the dormant Commerce Clause, is absolutely identical in both cases. The five items of inaction found by the California Supreme Court to constitute congressional consent in *Barclays* are *exactly* the same items of inaction relied on by the court of appeal to find congressional consent in this case. *See Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th at 733 (1992); *see also* Pet. App.-16a. To be sure, it was because the congressional inac-

tion that was at issue was identical in both cases that the California court of appeal found itself "obligated to adopt the analysis in *Barclays*" that Congress had consented to states' use of worldwide combined reporting. Pet. App.-18a.

If the Court grants the petition in *Barclays,* but does not grant the petition in this case, it could lead to the exact same set of facts being found to constitute congressional consent in one case, and not in another. Not only would this result be constitutionally unacceptable where the only difference between the two cases lies in the domicile of the taxpayer, but also it would result in considerable confusion over whether there is a different standard of congressional consent for domestic-based multinationals than for foreign-based multinationals. If this Court grants the petition in *Barclays,* therefore, it must grant the petition in this case in order to ensure that the ultimate disposition of the two cases is the same.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT CORCORAN
Counsel of Record
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-8103

MONA C. ZEIBERG
NATIONAL CHAMBER LITIGATION CENTER, INC.
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

Attorney for Amicus Curiae
The Chamber of Commerce
of The United States of America

Supreme Court, U.S.
FILED
DEC 15 1993
OFFICE OF THE CLERK

No. 92-1839

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency Of The State Of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California In and for the Third Appellate District

JOINT APPENDIX

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
FRANKLIN C. LATCHAM
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

DANIEL E. LUNGREN
Attorney General of the State of California
TIMOTHY G. LADDISH
Assistant Attorney General
LAWRENCE K. KEETHE
Supervising Deputy Attorney General
CLAUDIA K. LAND
Supervising Tax Counsel
Franchise Tax Board
JOHN D. SCHELL
Deputy Attorney General
Counsel of Record
P.O. Box 944255
Sacramento, CA 94244-2550
(916) 324-5165
Counsel for Respondent

PETITION FOR CERTIORARI FILED MAY 19, 1993
CERTIORARI GRANTED NOVEMBER 1, 1993

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Letter from the Right Honorable Michael Grylls to Secretary of the Treasury Nicholas Brady, dated October 23, 1991 and attached to Colgate-Palmolive Company's Opening Brief on the Merits in the California Supreme Court 52

The following opinions have been omitted in printing this joint appendix because they appear on the following pages in the appendix to the printed Petition for Certiorari:

Opinion of the California Court of Appeal, Third Appellate District, on Transfer from the California Supreme Court, November 20, 1992 ..... 2a

Opinion of the California Court of Appeal, Third Appellate District, August 20, 1991 ..... 29a

Decision of the California Superior Court, County of Sacramento, April 19, 1989 ..... 74a

CHRONOLOGICAL LIST OF DOCKET ENTRIES

DATE	PROCEEDINGS
April 26, 1984	Complaint filed in California Superior Court, County of Sacramento.
June 7, 1984	Answer on behalf of Defendant, Franchise Tax Board, filed.
July 7- July 26, 1988	Proceedings before the Honorable Robert Gardner, Judge Pro Tem, California Superior Court.
April 19, 1989	Decision filed by Honorable Robert Gardner, Judge Pro Tem, California Superior Court [text printed in Appendix F to Petition for a Writ of Certiorari (the "Petition") at 74a].
June 15, 1989	Judgment
May 15, 1990	Appellant Franchise Tax Board's brief filed with California Court of Appeal, Third Appellate District.
October 17, 1990	Respondent Colgate's brief filed with California Court of Appeal, Third Appellate District.
Dec. 10, 1990	Appellant's Reply Brief filed with California Court of Appeal, Third Appellate District.
August 20, 1991	Opinion of the California Court of Appeal, Third Appellate District [text printed in Appendix E to the Petition at 29a].
Sept. 4, 1991	Respondent Colgate's Petition for Rehearing filed with California Court of Appeal, Third Appellate District.
Sept. 11, 1991	Answer to Respondent's Petition for Rehearing filed with California Court of Appeal, Third Appellate District.
Sept. 16, 1991	Order of California Court of Appeal, Third Appellate District, denying Rehearing.
Sept. 30, 1991	Colgate's Petition for Review filed in the California Supreme Court.

DATE	PROCEEDINGS
October 21, 1991	Franchise Tax Board's Answer to Petition for Review filed in the California Supreme Court.
October 31, 1991	Colgate's Reply to the Answer to the Petition for Review filed in the California Supreme Court.
Nov. 27, 1991	Order of the California Supreme Court granting review [text printed in Appendix D to the Petition at 28a].
Feb. 24, 1992	Colgate's Opening Brief on the Merits filed in the California Supreme Court.
June 18, 1992	Order of the California Supreme Court transferring case to the California Court of Appeal [text printed in Appendix C to the Petition at 27a].
August 31, 1992	Colgate's Supplemental Brief on transfer from the California Supreme Court filed.
August 31, 1992	Franchise Tax Board's Supplemental Brief on transfer from the California Supreme Court filed.
Nov. 20, 1992	Opinion of the Court of Appeal on transfer [text printed in Appendix B to the Petition at 2a].
Dec. 30, 1992	Colgate's Petition for Review filed in the California Supreme Court.
January 1, 1993	Franchise Tax Board's Answer to the Petition for Review filed in the California Supreme Court.
January 29, 1993	Colgate's Reply to the Answer to the Petition for Review filed in the California Supreme Court.
Feb. 18, 1993	Order of the California Supreme Court denying review [text printed in Appendix A to the Petition at 1a].

SUPERIOR COURT
OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF SACRAMENTO

No. 319715

COLGATE-PALMOLIVE CO.,
a Delaware Corporation,
Plaintiff,

v.

FRANCHISE TAX BOARD,
an Agency of the State of California,
Defendant.

JOINT STIPULATION

Trial Date: July 13, 1988
Before Honorable Robert Gardner

IT IS HEREBY STIPULATED by and between Colgate-Palmolive Company and the Franchise Tax Board, through their attorneys of record, that the following facts are agreed and undisputed. This Stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived in this Stipulation.

All documents referred to herein or specifically enumerated are compiled under separate cover, have been reviewed by counsel for the parties, and their authenticity

is admitted. Pursuant to Evidence Code § 1511, to the extent that the originals of any of these documents are ultimately determined to be admissible, photocopies of these documents will be admissible for purposes of trial in place of the originals.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proven in open court.

FACTS

The following facts are agreed and undisputed:

1. During the income years 1970, 1971, 1972 and 1973, plaintiff Colgate-Palmolive Company was a corporation organized and existing under the laws of Delaware, was headquartered in New York, and was qualified to do, and was doing, business in the State of California. Colgate-Palmolive Company and its subsidiaries doing business in the United States (with the exception of subsidiaries acquired in 1972 and 1973, *i.e.* The Kendall Company and Helena Rubenstein, Inc.) are hereinafter referred to collectively as "Colgate".

2. Colgate timely filed California franchise tax returns for the income years 1970 through 1973. Those returns are designated as Joint Exhibits 2a, 2b, 2c, and 2d, respectively.

3. Upon audit of those returns, the Franchise Tax Board of the State of California ("FTB") issued Notices of Additional Tax Proposed to be Assessed for each of the income years 1970 through 1973. Those notices are designated as Joint Exhibits 3a, 3b, 3c, and 3d, respectively.

4. Plaintiff timely protested the proposed assessments. After consideration of the protest, the FTB issued Notices of Action on Taxpayer's Protest for the income years 1970 through 1973, which are designated as Joint Exhibits 4a, 4b, 4c, and 4d, respectively.

5. Plaintiff also filed with the FTB a petition pursuant to § 25137 of the Revenue & Taxation Code for the income years 1970 through 1973. The transcripts of the hearing before the FTB on that petition is designated as Joint Exhibit 5.

6. After the hearing, the FTB adopted the resolution regarding the § 25137 petition of Colgate which is designated as Joint Exhibit 6.

7. After paying the amounts reflected on the Notices of Action on Taxpayer's Protest, Colgate timely filed claims for refund for the income years 1970 through 1973, which are designated as Joint Exhibits 7a, 7b, 7c and 7d, respectively.

8. During the income years 1970 through 1973, 75 subsidiaries of Colgate operated in 53 foreign countries. The subsidiaries operating in foreign countries are collectively referred to as the "foreign subsidiaries". A list of those subsidiaries, including the city and country in which they are headquartered and the year in which they commenced operations, is designated as Joint Exhibit 8.

. . .

28. The United States Department of Justice and the Government of the United Kingdom have filed briefs *amicus curiae* in the consolidated cases of *Barclay's Bank of California* v. *Franchise Tax Board*, No. 325061 (Sacramento Superior Court) and *Barclay's Bank International, Ltd.* v. *Franchise Tax Board*, No. 325059 (Sacramento Superior Court). The brief *amicus curiae* of the Department of Justice is designated as Joint Exhibit 28a, and the brief of the United Kingdom is designated as Joint Exhibit 28b. The order of the Sacramento Superior Court adopting the intended decision in the consolidated *Barclay's* [sic] cases is designated Joint Ex-

hibit 28c. The FTB's opening appellate brief in the consolidated *Barclay's* case is attached as Joint Exhibit 28d.

. . .

71. If it is ultimately determined in this case that the FTB may not combine Colgate with the foreign subsidiaries in a single, worldwide unitary group, then the taxable income, California apportionment percentage, California business income, total franchise tax, tax previously paid, and amount of refund of tax due to Colgate (not including interest to be computed under Section 26080 of the Revenue and Taxation Code) are as follows:

Income Year	Taxable Income	California Apportionment Percentage	California Business Income
1970	$25,652,055	9.31920%	$2,390,566
1971	27,520,141	9.01730%	2,481,574
1972	32,440,358	9.21640%	2,989,833
1973	36,554,062	8.88730%	3,248,669

Income Year	Franchise Tax	Tax Previously Paid	Refund of Tax
1970	$167,340	$ 283,356	$116,016
1971	173,710	311,997	138,287
1972	227,227	379,529	152,302
1973	269,640	467,800	198,160
TOTAL	$837,917	$1,442,682	$604,765

. . .

This Stipulation is made this 13th day of July, 1988.

WILLIAM ALSUP
JAMES P. KLEIER
MONIQUE VAN YZERLOOY
MORRISON & FOERSTER

By _____
WILLIAM ALSUP
Counsel for Plaintiffs

JOHN VAN DE KAMP
Attorney General of the State of California
ROBERT F. TYLER
Supervising Deputy Attorney General

By _____
JOHN D. SCHELL
Deputy Attorney General
Counsel for Defendant

[In the Superior Court of the State of California
for the County of Sacramento]

PLAINTIFF'S EXHIBIT 1

THE WHITE HOUSE
Office of the Press Secretary

For Immediate Release November 8, 1985

STATEMENT BY THE PRESIDENT

Since early in this Administration, we have been working with the states, the business community, and foreign governments in an effort to resolve issues related to state use of the worldwide unitary method of taxation. At this time I believe it appropriate for the Federal Government to state its support for the concept of legislation that would:

1. Effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ("the water's edge requirement"); and
2. Address the question of equitable taxation of foreign source dividends.

We hoped that by this time these principles would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law and to work with the Congress for passage, and also, where appropriate, to enter into negotiations to amend double taxation agreements. I am also instructing the Secretary of the Treasury to pursue enactment of the domestic "spreadsheet" legislation, which has been previously proposed,

and which is designed to assist nonunitary states with tax enforcement respecting multinational corporations in order to promote full taxpayer disclosure and accountability.

Further, I am instructing the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach.

. . .

[In the Superior Court of the State of California
for the County of Sacramento]

PLAINTIFF'S EXHIBIT 2

THE SECRETARY OF STATE
Washington

Jan. 30 1986

The Honorable
George Deukmejian,
Governor of California,
Sacramento.

Dear Governor Deukmejian:

As you are aware, federal legislation was recently introduced with the full support of the Administration which would prohibit states from taxing corporations under the worldwide unitary method and from taxing more than an equitable share of foreign source dividends. This action was taken at the express direction of the President. I am writing to explain to you the foreign policy concerns that prompted this legislation and to urge you to act promptly to reconsider your state's use of the worldwide unitary method of taxation.

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different methods are in use for making the determination with respect to transnational income: separate accounting and worldwide unitary combination. The longstanding policy of the federal government has been to follow the separate accounting method. The United States has advocated and adopted the position that the "arm's-length" adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed. This

view is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. It is prescribed in the model income tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") and by foreign country tax systems generally. In contrast, the worldwide unitary method of taxation is followed only by seven of the U.S. states. Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

In an environment in which separate accounting is the federal policy and the generally accepted international rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs and property values vary sharply on an international basis, the rates of profitability of affiliates operating within and without the jurisdiction of the unitary state are often different. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis. This risk of double taxation may distort investment decisions, thereby reducing the overall flow of investment into the United States.

Our concern over the worldwide unitary method of taxation's inhibiting effect on foreign investment in the United States is shared by many foreign governments. They have advised us of their view that "The [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." They contend that the unitary method of taxation constitutes ". . . a serious obstacle to the further development of our trade and investment relationships." (Diplomatic note signed by the Ambassadors of Australia, Belgium, Canada, Denmark, France, Federal Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, and Switzerland.)

The administration of the worldwide unitary method of taxation also imposes unreasonable and costly compliance burdens on an enterprise which is considered to be part of a worldwide unitary group. The information required by the tax authorities of the jurisdiction practicing a worldwide unitary method of taxation may not be readily available to the enterprise and, in the case of foreign-controlled entities which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other reason, will require costly conversion into a form usable by the jurisdiction's tax authority.

For these reasons I believe state worldwide unitary taxation to be inappropriate. Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies. During my tenure as Secretary of State, this has been a difficult and long-lasting issue. The Department of State has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world. The unitary issue has been partially responsible for stalling some bilateral tax treaty negotiations.

Most seriously, the U.K. Parliament, in July, 1985, unanimously adopted anti-unitary retaliatory legislation permitting the U.K. government to deny, on a unilateral basis and retroactive to April, 1985, a very valuable benefit of the U.S.-U.K. tax treaty for U.S. corporations operating in worldwide unitary states. This legislation, by virtue of a provision which makes possible the retroactive

imposition of heavy penalties, was having a chilling effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States and on their willingness to claim benefits properly available to them under the treaty. While the U.K. has agreed to defer implementation of this legislation for the time being, this incident makes it clear that state worldwide unitary taxation is adversely affecting the United States' foreign economic relations.

While the Administration has proposed federal legislation prohibiting worldwide unitary taxation and limiting state taxation of foreign dividends, I would welcome swift legislative or administrative action by your state to terminate your state's use of the worldwide unitary method of taxation and to limit appropriately your state's taxation of foreign source dividends.

Sincerely yours,

/s/ George P. Shultz
GEORGE P. SHULTZ

[In the Superior Court of the State of California
for the County of Sacramento]

PLAINTIFF'S EXHIBIT 3

[LOGO]

THE SECRETARY OF THE TREASURY
Washington

March 5, 1986

Dear Bob:

S. 1974, introduced by Senator Wilson, as well as Senators Mathias and Hawkins, in the Senate on December 18, 1985, would generally prohibit states from levying corporate income taxes on a worldwide unitary basis. This legislation falls within the jurisdiction of the Senate Finance Committee. The bill was drafted by the Treasury Department at the express direction of the President and has the full support of the Administration. I have attached for your consideration a copy of the President's statement of November 8, 1985 on the worldwide unitary tax issue, directing me to prepare and submit this legislation to Congress. A technical explanation of the bill, providing a complete description of its provisions, is also enclosed. This letter is intended to provide you with background on the worldwide unitary tax issue and to describe the serious concerns that have led the Administration to propose and support this legislation.

I. *Description of Current State Corporate Income Tax Practice*

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different taxation methods are in use for making this determination: separate accounting and worldwide unitary combination.

Separate accounting is the method of taxation in use generally throughout the world and is employed by the fed-

eral government. Under separate accounting, taxable income is determined separately for each individual corporation. Any improper income or profit shifting between related corporations for tax avoidance purposes is corrected by requiring "arm's length" pricing in related party transactions. That is, flows of goods and services between related or commonly-owned corporations are required to be valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's length. Under the separate accounting method, double taxation between jurisdictions is relieved either through exemption from tax by the residence jurisdiction (usually the place of incorporation or management control) of income derived in the source jurisdiction (the place the income is earned), or by the residence jurisdiction granting a credit for taxes paid to the source jurisdiction. The United States federal tax law uses the latter approach.

The alternative method, worldwide unitary combination, is currently used by seven states (Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah *) to determine a multinational enterprise's state corporate tax liability. Under this approach, the business income of all individual companies in the commonly controlled enterprise which operate in the same general line of business (the "unitary business") as the corporation or corporations subject to the state's taxing jurisdiction is aggregated, regardless of (i) whether the other individual companies are foreign or domestic; (ii) whether the other individual companies have a tax nexus with or presence in the state in question; and (iii) whether the income of the other individual companies would be treated as derived from foreign or domestic sources under federal

* Utah has adopted administrative rules that would abandon worldwide unitary taxation upon implementation of certain federal assistance measures, including the enactment of the federal assistance legislation contained in the proposed bill and described in section IV, below.

tax rules or generally accepted international taxation principles. A share of the aggregated income of the worldwide unitary group is then assigned or apportioned to the taxing state on the basis of a formula which is intended to measure how much of the activity of the unitary business (and hence its income) is attributable to the taxing jurisdiction.

The apportionment formula generally used is based on relative amounts of payroll, property, and sales. If, for example, 25 percent of the payroll, property, and sales of the unitary group is located in the taxing jurisdiction, then 25 percent of the group's aggregate income from the unitary business would be apportioned to that state. Because the apportionment formula is considered to assign the appropriate amount of income to a particular state, no further measures are taken to relieve any multiple taxation of the same income which may arise from the use of different income sourcing rules by other taxing jurisdictions.

Under the worldwide unitary method, dividends paid by one corporation to another within the unitary business group are eliminated as intercorporate transfers. Under separate accounting, in contrast, intercorporate dividends are recognized explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A "water's edge" limitation on the unitary method, i.e., excluding foreign corporations, would respect the separate entity status of related domestic and foreign corporations. It therefore gives rise to the question of how dividends received by a U.S. corporation that is a member of a "water's edge" unitary group from a foreign corporation that is not a member of the "water's edge" group should be treated for state tax purposes. The question of state taxation of foreign-source dividends is thus inextricably linked to the issue of worldwide unitary taxation and, as described below, is therefore addressed in the proposed legislation.

Under present law, state taxation of intercorporate dividends, foreign and domestic, exhibits a range of practice. Though dividends from a domestic corporation are subject to tax in nearly all states with a corporate income tax, most of these states also grant a dividends-received deduction, frequently the 85 percent or 100 percent deduction allowed under federal law. As at the federal level, the effect of this treatment is largely to exempt dividends paid by a domestic corporation from state corporate income taxation. Dividends received from a foreign corporation are subject to varying treatment, ranging from full allocation (and thus taxation) to the recipient's commercial domicile, to apportionment, to either full or partial exemption. Unlike the federal government, no state alleviates international double taxation of foreign dividends by allowing a foreign tax credit.

II. *Reasons for Administration Opposition to Worldwide Unitary Taxation*

It has been the longstanding policy of the United States to favor the separate accounting method for allocating income among nations for purposes of taxation. This policy is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. The model tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") specify that transnational income is to be taxed on a separate accounting basis. Thus, continued state worldwide unitary taxation is directly in conflict with federal and internationally accepted practice and impedes the ability of the federal government to pursue this policy in its international dealings.

During the debate over worldwide unitary taxation, foreign governments have repeatedly petitioned the federal government to act to curb state use of the worldwide unitary method. Diplomatic notes articulating the problems

caused by state worldwide unitary taxation have been received from virtually every developed country in the world, including Canada, the United Kingdom, Germany, France, Belgium, the Netherlands, Italy, Switzerland, Japan, and Australia. The United Kingdom, in July, 1985, adopted anti-unitary retaliatory legislation that would permit the U.K. government to effectively increase the U.K. tax on dividend distributions from U.K. subsidiaries to their U.S. parent corporations operating in worldwide unitary states. If implemented, this legislation would clearly violate the U.S.-U.K. bilateral income tax treaty. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having an adverse effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States. (The U.K. has now agreed to defer implementation of this legislation for the time being.) The adoption of this legislation by the U.K. illustrates that state worldwide unitary taxation is clearly adversely affecting the United States' foreign economic relations.

Foreign governments and businesses that are subject to worldwide unitary taxation argue that this method of computing state tax gives rise to double taxation of foreign income. They also contend that worldwide unitary taxation is administratively burdensome, particularly for foreign owned companies. These results are inevitable as long as a few states rely on a method of measuring income that is different from the approach used by the rest of the world.

Theoretically, if all jurisdictions, domestic and foreign, were to adopt a uniform unitary method of taxation, and apply it consistently, there would be no double taxation as the formula would not apportion the same income to more than one jurisdiction. The problem, however, arises from the fact that combined reporting on a worldwide unitary basis is a distinctly minority practice. In an en-

vironment in which separate accounting is the generally accepted rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs, property values, and profitability can vary greatly among countries, an income measurement system based on formula apportionment is in open conflict with the international standard of separate accounting. This is because formula apportionment assumes all parts of a unitary business are equally profitable whereas separate accounting acknowledges that individual corporations can earn different rates of return. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis.

State use of the worldwide unitary method also creates administrative burdens for taxpayers. There are substantial costs associated with collecting and converting accounting data generated by the various foreign affiliates of the unitary group to a form consistent with U.S. standards. These burdens can be particularly acute for foreign-owned companies which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other purpose.

The use of the worldwide unitary method by some states may also inhibit and distort the international flow of investment capital. In the words of one foreign government, "[t]he [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." Consequently, according to a group of foreign governments, worldwide unitary tax constitutes ". . . a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). The United States is strongly committed to encouraging

the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer. Some states may be in a position in which their use of the unitary method causes foreign investors to turn away from the United States altogether (rather than shift investments to other U.S. states).

In September 1983, in response to complaints raised by both the U.S. and foreign business community and foreign governments over the Supreme Court decision in *Container Corp.* v. *Franchise Tax Board*, President Reagan asked then Treasury Secretary Donald Regan to establish and chair a Worldwide Unitary Taxation Working Group. This group was composed of representatives of the federal government, state governments, and the business community and was asked to provide recommendations suitable for resolving the issues raised by worldwide unitary taxation.

At its final meeting on May 1, 1984, the Worldwide Unitary Taxation Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

Principle 1:

> "Water's edge" unitary combination for both U.S.- and foreign-based companies.

Principle 2:

> Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

Principle 3:

> Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

While the first and third principles were to be adopted voluntarily on a state-by-state basis, Principle 1, in particular, represented a clear recognition by the Working Group that the separate accounting method was superior to the worldwide unitary method in the international context. The Administration was very hopeful that the states would be able to resolve the worldwide unitary problem along the lines advocated by the Working Group on a voluntary basis without resort to federal legislative intervention.

Since the adoption of the Working Group Report some states have changed their laws to conform to the Working Group principles. Florida, Colorado, Indiana and Oregon have ceased taxing on a worldwide unitary basis. A Massachusetts court decision imposed limitations on that state's use of the worldwide unitary method and the state legislature has to date refrained from taking any action that would permit application of that method in the face of the judicial decision. However, seven other states continue to use the worldwide unitary method. In particular, efforts in California to enact legislation limiting worldwide unitary taxation have foundered in the past two legislative sessions, most recently when the California legislature adjourned for the year in September, 1985 without taking action on the issue.

In transmitting the report of the Working Group to the President, Secretary Regan indicated that he would recommend restrictive federal legislation if substantial voluntary progress had not been made on the worldwide unitary issue at the state level by July 31, 1985. That date has long since passed. We now believe that the time has come for Congress to act to finally resolve this serious international economic problem.

III. *State Taxation of Foreign-Source Dividends*

The taxation of foreign-source dividends is directly related to the issue of worldwide unitary taxation. A limited resolution of the worldwide unitary issue—such as an agreement by states not to impose worldwide unitary tax but with no restriction on the taxation of foreign-source intercorporate dividends—would cause other serious problems. In effect, this would be a "foreign only" situation, freeing foreign-owned multinationals from the yoke of worldwide unitary taxation while subjecting U.S. based multinationals to full taxation on their foreign dividend income. Such a "foreign only" solution, if adopted, would disadvantage domestically controlled businesses. The Working Group's third principle recognizes the need for competitive balance for domestic multinationals, foreign multinationals, and purely domestic businesses. That principle requires that legislation restricting state unitary taxation also address the question of equitable state taxation of foreign-source dividends. Unrelieved state taxation of foreign dividends is not consistent with Principle 3.

Unrestricted state taxation of foreign dividends would subject domestic businesses to serious double taxation of foreign income. Federal tax policy has long been characterized by its commitment to avoid international double taxation. Indeed, the United States has been a leader in a worldwide effort to establish taxing rules under treaties and commonly accepted principles that minimize international double taxation. If a clear federal policy is not to be undercut by state action, states must comply with this policy of eliminating double taxation and therefore be limited to taxing some equitable portion of foreign source dividends.

The legislation does not mandate that any specific method of dividend taxation be imposed on the states. In our view, arguments of state fiscal sovereignty strongly indicate that states should have leeway to tailor their own

systems of taxation to the extent that they do not cause serious foreign commerce difficulties by resulting in systematic overtaxation and double taxation of U.S. business in contravention of established federal and international policy. The legislation therefore provides in broad terms for the equitable taxation of dividends and suggests certain guidelines that states could follow in satisfying that standard. As an illustration of the flexibility of the approach, the legislation would accept as appropriate the treatment of dividends in such states as Colorado, Oregon, Florida and Illinois, states which have been intimately involved in the worldwide unitary tax controversy.

IV. *Information Reporting and Other Federal Assistance*

States have legitimately contended in the Working Group and elsewhere that they lack the resources and ability to monitor adequately transactions between members of a water's edge unitary group and related foreign companies outside that group. The Treasury Department agreed with recommendations of the Working Group to provide appropriate federal assistance to the states in order to assure proper working of the separate accounting method. The Working Group suggested that an annual information return be filed with the Internal Revenue Service by multinational companies. This return would in turn be shared with the states and with multistate audit agencies and would provide states with some assurance that corporations had allocated and apportioned the appropriate share of the corporation's income to each state. The report would also identify those related companies with which serious income shifting would be most likely to arise. In the summer of 1985, the Treasury Department published for comment a draft of legislation implementing this reporting system. Section 3 of the bill is based upon that draft after taking into account the many comments received from affected businesses and the various states. We believe that the information reporting system provided for in the bill is an integral part of the solution to the worldwide unitary problem.

In order to provide states with greater assistance the Treasury Department also indicated in the Working Group an intention to increase the resources devoted to the IRS's administration of tax laws applicable to foreign operations of multinational companies. I urge your assistance in approving the increased budget appropriations that are being requested for this purpose.

Conclusion

I strongly urge the prompt and favorable consideration of this legislation by the Finance Committee. The serious foreign commerce difficulties caused by the use of the worldwide unitary tax method by a few states must now be resolved.

OMB has advised that there is no objection from the standpoint of the Administration's program to the presentation of this legislation to the Congress and that its enactment would be in accord with the program of the President.

Sincerely,

/s/ Jim
JAMES A. BAKER, III

The Honorable Bob Packwood
Chairman, Finance Committee
United States Senate
Washington, D.C. 20510

(Attachments omitted in printing)

[In the Superior Court of the State of California
for the County of Sacramento]

JOINT EXHIBIT 34b

DEPARTMENT OF THE TREASURY
Washington

[LOGO]

Assistant Secretary

Dear Governor Deukmejian:

The Department of the Treasury recently received and studied with interest the Franchise Tax Board's "Report to the Legislature on 80-20 Corporations, As Mandated by Senate Bill 85, Section 14 (Stats. 1986, Ch. 660)". There are two issues addressed in the Report which we feel compelled to comment upon. These issues deal with Internal Revenue Service audits of federal consolidated returns and the Administration's desire for equitable state tax treatment of foreign and domestic corporations. We hope that you will take these comments into consideration in developing legislation to address the "80-20" issue.

The IRS Audit Issue

The first issue involves Internal Revenue Service audits of 80-20 corporations. The Report asserts that "[an Internal Revenue Code section 861] sourcing audit need not, and does not, include examination of potential shifting of income between entities" of a federal consolidated filing group. Although it is accurate to say that it does not matter for many federal purposes which member of the group has the foreign source income, section 482 arm's-length pricing adjustments are used to prevent the shifting of income within the group from U.S. to foreign sources.

In auditing Federal consolidated returns, section 482 arm's-length pricing principles are used not only to audit transactions between the consolidated return group and

other entities, but also to audit transactions within the group in order to determine the foreign source income of the consolidated group. That is, when a member of a consolidated group asserts that it has derived foreign source income from a transaction with another group member, section 861 is used to determine whether the income is foreign source and section 482 is used to allocate income from that transaction using arm's length pricing principles. Furthermore, in the future, these intra-group section 482 pricing audits will be used even more extensively in light of the tremendous pressure which the Tax Reform Act of 1986 has put on correct calculation of the foreign tax credit limitation. For these reasons, we feel that California can place reliance upon the Internal Revenue Service to determine the foreign source income of any 80-20 corporations included in a federal consolidated return.

The Equity Issue

In developing good tax policy, the principle that taxpayers in similar situations should face similar tax burdens should be followed unless there are overwhelming reasons to the contrary. The "equity issue" in the 80-20 corporation debate is based on this principle. For taxpayers electing "water's edge" treatment under the Senate Bill 85 (Stats. 1986, Ch. 660), foreign corporations with more than 80 percent of their business activity outside the United States are excluded from unitary combined income subject to apportionment and taxation in California. However, the new statute specifically includes domestic corporations, otherwise in the identical circumstances, within the water's edge combination.

While recognizing that there may be revenue or administrative reasons for different tax regimes for foreign subsidiaries and 80-20 corporations, we feel that the Franchise Tax Board Report fails to address adequately the policy considerations underlying the equity issue. Although the Report correctly points out that this issue in-

volves a judgmental determination, rather than a factual question, the Report, in our view, fails to provide any basis for a rational policy distinction.

For example, the Report merely advances as a counter-argument that there are separate tax structures for corporations, individuals, and partnerships and that there are different federal tax treatments of domestic and foreign corporations. In doing so, however, the Report fails to point out that the different tax structures of corporations, individuals, and partnerships are based upon substantial differences in form and that federal taxation of domestic corporations is on a residence basis, taxing worldwide income, while taxation of foreign corporations is based on a source and business activity basis, taxing certain U.S. source income and all income from both U.S. and non-U.S. sources that is effectively connected with a foreign corporation's U.S. trade or business.

The Report further asserts, without example or analysis, that taxation of 80/20 corporations on an apportionment basis does not appear to be competitively disadvantageous in comparison to controlled foreign corporations which face taxation of 25 percent of repatriated dividends on an allocation basis. That is, the report simply states that, because the taxpayers in question might end up facing similar tax burdens, the principle of equity is satisfied. We fail to see how this simple assertion that the tax burdens between domestic and foreign corporations under California law might, by coincidence, be comparable can excuse a policy of subjecting them to different tax structures.

We encourage you to analyze more fully the policy considerations underlying the equity issue. We hope that, when you do so, you will agree 1) that when water's edge unitary combinations are defined on the basis of business activity, place of incorporation should be irrelevant; 2) that there is no valid policy justification for California's subjecting two taxpayers, for example, one with a Delaware subsidiary operating primarily abroad,

the other whose foreign operations are conducted through a French subsidiary, to different tax regimes; and 3) that in this era of trade competitiveness, the potential for inflicting higher tax burdens on corporations with 80-20 operations, as opposed to foreign subsidiary operations, should be avoided.

In summary, we feel that the Report misrepresents what we regard as adequate section 482 audit coverage by the IRS of foreign source income reported on consolidated returns and that the Report fails to examine the policy concerns underlying the equity issue. We would remind you that we identified California's treatment of 80-20 corporations as an element of federal concern in testimony last September on S.1974, legislation which would impose federal restrictions on state's use of the unitary combination method of corporate taxation. In that testimony, the Administration stated that "we do not recommend adoption of restrictive federal legislation at this time. [However,] We believe further progress is required to address the concerns we have raised and, if such progress is not forthcoming within a reasonable time frame, we may recommend reconsideration of the legislation in the future". While we would greatly prefer a state solution to the unitary issue, the Administration will accept such a solution only if it fairly deals with the important issues delineated in our testimony, which include the 80-20 issue. I therefore urge you to search for an answer to this issue beyond the Franchise Tax Board's Report.

Sincerely,

/s/ J. Roger Mentz
J. ROGER MENTZ
Assistant Secretary
(Tax Policy)

The Honorable George Deukmejian
Governor of the State of California
State Capitol
Sacramento, California 95814

[In the Superior Court of the State of California
for the County of Sacramento]

JOINT EXHIBIT 64

[LOGO]

U.S. DEPARTMENT OF JUSTICE
Tax Division

Assistant Attorney General

Washington, D.C. 20530
January 27, 1988

William H. Alsup, Esquire
Morrison & Foerster
345 California Street
San Francisco, California 94104-2105

Re: Colgate-Palmolive Co. v. Franchise Tax Board, California Superior Court, Sacramento County No. 319715

Dear Mr. Alsup:

Pursuant to your request, this is to confirm that the statements contained in the December 19, 1986, letter to Mr. Franklin C. Latcham from my predecessor, Assistant Attorney General Roger M. Olsen, a copy of which is attached, continue to reflect the position of the Government.

Sincerely yours,

/s/ William S. Rose, Jr.
WILLIAM S. ROSE, JR.
Assistant Attorney General
Tax Division

Enclosure

[Attachment to Joint Exhibit 64]

[LOGO]

U.S. DEPARTMENT OF JUSTICE
Tax Division

Assistant Attorney General

Washington, D.C. 20530
December 19, 1986

Mr. Franklin C. Latcham
Morrison & Foerster
California Center
345 California Street
San Francisco, California 94104-2105

Re: Colgate Palmolive Co. v. Franchise Tax Board
(Cal. Superior Ct. Sacramento County
No. 319715

Dear Mr. Latcham:

This letter is in response to your request concerning the position taken by the United States in *Barclays Bank of California* v. *Franchise Tax Board,* Civil No. 325061, and *Barclays Bank International, Ltd.* v. *Franchise Tax Board,* Civil No. 325059, pending before the Superior Court of the State of California for Sacramento County, and in *Alcan Aluminum* v. *The Franchise Tax Board of the State of California,* Civil No. 84-C-6932, and *Imperial Chemical Industries PLC* v. *Franchise Tax Board of the State of California,* Civil No. 84-C-8906, pending before the United States District Court for the Northern District of Illinois, Eastern Division. Those cases involved the appropriateness of taxation of the plaintiffs on a worldwide unitary basis under California law prior to the September, 1986, amendment thereto.

In those cases the United States filed briefs amicus curiae wherein it stated its position on the above-stated issue. Enclosed herein are true copies of those amicus

briefs. As you will note, I appeared as counsel of record for the United States on those briefs. Please be advised that the Department of Justice has not been advised of any change in the position of the United States as set forth in those briefs.

Sincerely yours,

/s/ Roger M. Olsen
ROGER M. OLSEN
Assistant Attorney General
Tax Division

Enclosures

[Attached to the Franchise Tax Board's Answer to the First Petition for Review]

LETTER FROM REUBEN MARK

August 16, 1991

Honorable Nicholas F. Brady
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Brady:

Your assistance is urgently required to prevent the federal government from inadvertently discriminating against American companies in favor of foreign companies. The federal government has been vigorously assisting foreign companies in upholding the federal policy against worldwide unitary taxation by the states, but has failed to provide the same assistance to American companies. It is now critical for the Department of the Treasury to go on record that this policy equally protects American companies, in order to avoid putting our nation at a severe disadvantage in the highly competitive world of foreign trade.

In a November 8, 1985 statement, President Reagan set forth the Executive Branch's policy opposing the worldwide unitary method of taxation. In that statement, he instructed the Secretary of Treasury to pursue legislation codifying this federal policy.

Recently, the California Court of Appeal ruled in Barclays Bank International Ltd. v. Franchise Tax Board, that worldwide unitary method is unconstitutional as applied to foreign-based multinationals. The court held that the worldwide unitary method interfered with U.S. foreign policy, as clearly expressed by the Executive

Branch. The court based this conclusion largely on the fact that the Department of Justice appeared before the court and filed an amicus brief expressing the federal government's policy.

Colgate is also litigating the constitutionality of the worldwide unitary method as it applies to U.S.-based multinational groups. Oral argument before the California Court of Appeal was recently heard. In contrast to the Barclays case, the Department of Justice neither appeared before the court nor filed an amicus brief.

The application of worldwide unitary taxation to U.S.-based multinationals, but not to foreign-based multinationals, would cede a tremendous advantage to the latter group. The worldwide unitary method assigns income to a particular state by comparing the unitary group's property, payroll and sales in the state with similar worldwide amounts. Because of higher wages and property values in the United States, the amount of income assigned to the state is artificially inflated. If this method is applied to U.S.-based multinationals, but not to foreign-based multinationals, then U.S. parent groups will pay substantially higher taxes on non-U.S. earnings than their foreign competitors, even if the only difference between the two is the place of the parent company's incorporation. In the highly competitive foreign trade area, we can not allow this to occur.

Additionally, the unitary method punishes U.S. companies which manufacture in the U.S. and export, rather than produce overseas. Companies such as Colgate which have significant exports but no imports are punished the most severely. This punishment through higher state taxes occurs in two ways. First, due to the mechanics of the unitary tax formula, employment of U.S. workers and investment in U.S. property raise state taxes. Secondly, higher U.S. wages and property values artificially raise state taxes a second time.

Foreign governments have been extremely active in voicing their opposition to the application of unitary taxation to their companies. Indeed, retaliatory foreign (U.K.) legislation would punish foreign affiliates of U.S. companies. The U.S. stands alone in allowing its companies to suffer this unfair foreign trade disadvantage.

It is now time for U.S. government to stand up and defend the right of American companies to a level playing field. This can only happen if the Executive Branch makes its opposition to unitary taxation of U.S.-based multinationals as explicit as it has its opposition to unitary taxation of foreign groups.

At oral argument in the Colgate case, the judges indicated that Colgate would lose because the Department of Justice neither appeared before the court nor filed an amicus brief explicitly supporting U.S.-based multinationals. The Court of Appeal appeared to view the absence of the Department of Justice or an amicus brief as decisive, notwithstanding the fact that, throughout the long history of federal opposition to worldwide unitary taxation, not one single indicia of this federal opposition has ever distinguished between U.S.-based and foreign-based multinationals. Indeed, it is preposterous to believe that the federal government would intend to discriminate against U.S.-based multinationals based solely upon the fact that the parent corporation is American.

American companies need and are entitled to the same support as the Executive Branch has provided to foreign companies such as Barclays. We are therefore urging the Executive Branch to announce explicitly that the federal policy against worldwide unitary taxation applies to U.S.-based multinationals. This announcement could be issued in any number of forms. We believe that the most effective means of communicating this federal policy would be the filing of an amicus brief in the Colgate case. Under the apparent view of the Court of Appeal, if this federal policy is not made explicit, worldwide unitary taxation will be unfairly applied solely to U.S-based multinationals.

Unfortunately, due to California's procedural rules, we have very little time in which to receive help from the federal government. Thus, if we are to prevent unfair discrimination against American companies, we would appreciate your assistance in convincing the Executive Branch to take prompt action.

If you would like further information or wish to discuss this matter, please telephone Steven Belasco, Vice President, Taxation at (212) 310-3032.

Thank you for your careful consideration of this matter.

Sincerely,

REUBEN MARK
Chairman, President and Chief
Executive Officer
Colgate-Palmolive Company
New York, New York

[Attached to Colgate's First Petition for Review
to the California Supreme Court]

LETTER FROM SECRETARY OF THE TREASURY

[LOGO]

THE SECRETARY OF THE TREASURY
Washington

September 13, 1991

Mr. Reuben Mark
Chairman, President and
Chief Executive Officer
Colgate-Palmolive Company
300 Park Avenue
New York, New York 10022

Dear Reuben:

Thank you for your letter of August 16 urging the United States to file an *amicus* brief or to make a policy statement to aid you in Colgate's litigation in California state courts regarding the constitutionality of the worldwide unitary method of taxation as it applies to U.S.-parent multinational corporations. I understand that you wrote similar letters to the Secretary of State, the U.S. Trade Representative, and the Acting Attorney General and that they are responding by referencing this letter so that you will receive a coordinated reply.

As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations. Treasury has testified before Congress that treaty-based limitations on worldwide unitary apportionment are "the least desirable of possible alternatives" (i.e., state or federal legislation) precisely because they would benefit foreign-

parent multinationals but not domestic-parent multinationals and thus not "satisfy the principle of ensuring competitive balance among similarly situated businesses." (*Cf.* Testimony of J. Roger Mentz, Treasury Assistant Secretary (Tax Policy), before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, September 29, 1986, page 3.) Our position has not changed.

We will continue to consult with the Departments of Justice and State regarding this issue and will promptly inform you if a decision is made to provide additional assistance. In the meantime, given the deadlines of your present litigation, I enclose for your use correspondence between former Governor Deukmejian and me and between the European Community representative and then-Acting Secretary Robson that outline our continuing opposition to California's use of worldwide unitary apportionment.

Sincerely,

/s/ Nick Brady

Enclosures

[Attachment to Secretary Brady's Letter at J.A. 35]

[LOGO]

THE SECRETARY OF THE TREASURY
Washington

August 23, 1989

The Honorable Lorenzo Gonzalez-Alonso
Minister for Economic and Commercial Affairs
Embassy of Spain
2558 Massachusetts Ave., N.W.
Washington, D.C. 20008-2865

Dear Mr. Gonzalez-Alonso:

Thank you for your letter of June 30, 1989, enclosing a copy of the letter of the same date from Ambassador Santamaria (on behalf of the Member States of the European Community) to Secretary of State James A. Baker III.

The issue of unitary taxation remains a serious concern to the Treasury Department and, indeed, to the Administration of President Bush. Although I do not want to comment on any particular matter of pending litigation, such as the case cited in Ambassador Santamaria's letter, I want to assure you of our continuing attention to this issue. We believe that states' use of the worldwide unitary tax method may constitute an impermissible interference in the conduct of the nation's foreign affairs, and further progress is required before Federal concerns on this issue can be put to rest.

Thus, we continue to endorse strongly the position taken by the prior Administration under which President Reagan instructed the Attorney General to ensure that the United States' interests are represented in appropriate

controversies and cases. We expect the Federal Government to continue to express its views on this matter when and where it is necessary and appropriate to do so.

Sincerely,

/s/ John E. Robson
JOHN E. ROBSON
Acting Secretary

[Attachment to Secretary Brady's Letter at J.A. 35]

Commercial Office
2559 Massachusetts Avenue, N.W.
Washington, D.C. 20008-2865
TEL. (202) 265-8600-01-02
TELEX: 64226 OFCOM UW
FAX: (202) 265-9478

[LOGO]

EMBASSY OF SPAIN
WASHINGTON, D.C.

IN REPLYING PLEASE REFER TO NO. 951-LGA/mv.

June 30th, 1989

The Honorable
Nicholas F. Brady
Secretary of the Treasury
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Sir:

I have the pleasure to enclose herewith a photocopy of the letter that the Ambassador of Spain has forwarded today, on behalf of the Member States of the European Community, to the Secretary of State, The Honorable James A. Baker, III, with respect to their opposition to the use of worldwide unitary tax by the State of California.

Sincerely,

/s/ Lorenzo González-Alonso
LORENZO GONZALEZ-ALONSO
Minister for Economic and
Commercial Affairs.

Enclosure.

[Attachment to Secretary Brady's Letter at J.A. 35]

[LOGO]

El Embajador de España

Washington, D.C., June 30th, 1989

The Honorable
James A. Baker, III
Secretary of State
U.S. Department of State
Washington, D.C. 20520

Dear Sir:

The Member States of the European Community have noted that the United States Supreme Court is shortly to hear an appeal against the judgement of the Seventh Circuit Court of Appeals in Imperial Chemical Industries plc and Alcan Aluminium Limited v. California Franchise Tax Board.

The EC Member States consider this to be an appropriate opportunity to restate their opposition to the use of worldwide unitary tax by the State of California. They would urge the United States Government to confirm that, like the previous Administration they, too, are opposed to the use of worldwide unitary tax.

The views of the EC Member States on worldwide unitary tax are well known.* They consider that the imposition of this tax is inconsistent with the internationally accepted principles underlying the Tax Treaties and Friendship Treaties that individual Member States have entered into with the United States. Specifically, the use of the tax by the State of California:

---

* Demarche of the EC Member States submitted to the U.S. Department of State: 19 March, 1980; 30 October, 1981; 29 June, 1982; 1 August, 1983; 23 September, 1983; 20 December, 1984; 8 August, 1985; 30 August, 1985.

i) contradicts the "arm's length" principal [sic] of allocating income of multi-national corporations between different national jurisdictions;

ii) may give rise to substantial double taxation;

iii) imposes a severe compliance burden by insisting on the restatement of accounts of different, but affiliated, corporations throughout the world even when they are not doing any business in California—accounts which were originally prepared to meet the specifications of the countries in which these corporations are resident;

iv) has perverse effects on the worldwide strategy of multi-national corporations (since, for example, a cost saving investment made in any country outside the U.S., can increase the tax liability in California, even if the California subsidiary is loss-making);

v) discriminates against companies doing business in California with subsidiaries, rather than through non-affiliated companies.

The EC Member States are strongly opposed to the attempt by California or any other State to impose taxation in [sic] income of foreign corporations arising outside the U.S.; to interfere with worldwide investment strategies, and to insist on burdensome compliance requirements on companies located outside the U.S.

EC Member States are aware that California has amended its legislation to allow multi-national companies to elect, on payment of a fee, to be taxed on a "water's edge", rather than worldwide unitary basis. However, since they are opposed to the use of worldwide unitary tax in principle, Member States cannot accept that it is right to insist on a fee as the price for electing to avoid worldwide unitary tax. Moreover, the process of making such an election involve substantial and unreasonable burdensome compliance costs.

The EC Member States, of course, support the case submitted by Imperial Chemical Industries and by Alcan Aluminium in the District Court and the Seventh Circuit Court of Appeal. They also very much endorse the *amicus* brief submitted by the U.S. in the District Court in ICI and Alcan v. California FTB. The EC Member States are aware that the issue currently before the Supreme Court is the question of the standing of the foreign parent companies to challenge the tax in the Federal courts, rather than the constitutionality of the tax itself. However, they believe the two issues to be inextricably interlinked. The EC Member States consider that worldwide unitary tax imposes an administrative and economic burden on foreign parent corporations and breaches the arm's length standard. Since the U.S. in its double taxation convention adheres to the internationally accepted arm's length principle, application of worldwide unitary tax by separate states of the U.S. prevents the U.S. from speaking with one voice when regulating commercial relations with foreign governments, and in the opinion of EC Member States is unconstitutional. The administrative and economic burden is imposed directly on foreign corporate parents and it is this constitutionally significant burden which creates standing for those foreign parents.

The Member States note and appreciate the U.S. Government's opposition to worldwide unitary tax. Given the importance of the present case before the Supreme Court, the Member States would urge the U.S. Government to reaffirm their commitment to the position taken by the previous Administration.

Sincerely,

/s/ Julian Santamaria
JULIAN SANTAMARIA
Ambassador of Spain

[Attachment to Secretary Brady's Letter at J.A. 35]

[LOGO]

THE SECRETARY OF THE TREASURY
Washington

August 3, 1989

The Honorable George Deukmejian
Governor of California
Sacramento, California 95814

Dear Governor Deukmejian:

I am writing in response to your letter of May 9, 1989, in which you expressed concern over continuing involvement of the Federal Government in state tax matters, specifically referring to the Justice Department's intervention in cases contesting California's use of worldwide unitary apportionment.

This Administration has given the issues raised in your letter serious consideration. We appreciate the substantial progress California has made in recent years in addressing the problems created for taxpayers by the use of worldwide unitary apportionment. Indeed, the Executive Branch's support of Federal water's-edge legislation has been withdrawn for the time being partly in recognition of that progress.

However, problems persist with our trading partners over states' use of the unitary method. Because of this issue's continuing international implications, it is not exclusively a state tax issue. We believe that states' use of the worldwide unitary tax method may constitute an impermissible interference in the conduct of the nation's foreign affairs, and further progress is required before Federal concerns on this issue can be put to rest.

Thus, we continue to endorse strongly the position taken by the prior Administration under which President

Reagan instructed the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases. Accordingly, this Administration supports the position taken in the United States' *amicus curiae* briefs filed in cases such as *Barclays Bank International, Ltd.* v. *Franchise Tax Board,* 3 Civ. C003388 and 3 Civ. C003389, Ct. App., 3rd App. Dis. We expect the Federal Government to continue to express its views on this matter when and where it is necessary and appropriate to do so. We hope, of course, that such intervention will not be necessary often.

Sincerely,

/s/ Nicholas F. Brady
NICHOLAS F. BRADY

[Attachment to Secretary Brady's Letter at J.A. 35]

OFFICE OF THE ATTORNEY GENERAL
Washington, D.C. 20530

[LOGO]

July 16, 1989

The Honorable George Deukmejian
Governor, State of California
Sacramento, California 95814

Dear George:

I wish to acknowledge your letter of May 9, 1989, in which you expressed concern over the Federal Government's participation in cases involving the constitutionality of the unitary tax method in determining the income tax liability of corporations doing business in the State of California.

The issue is an important one which affects not only the Department of Justice but the Departments of State and Treasury as well. I expect that Treasury Secretary Brady will be responding to you on behalf of the Administration in several days.

Sincerely,

/s/ Dick Thornburgh
DICK THORNBURGH
Attorney General

bcc: Nicholas F. Brady

[Attachment to Secretary Brady's Letter at J.A. 35]

STATE OF CALIFORNIA

[LOGO]

May 9, 1989

The Honorable Nicholas Brady
Secretary of Treasury
United States Department of Treasury
1500 Pennsylvania Avenue, N.W., Room 3330
Washington, D.C. 20220

Dear Mr. Brady:

The purpose of this letter is to express my concern over the continuing involvement of the federal government in state tax matters. During the prior administration, California worked very closely with the federal government and other states in an effort to respond to concerns of our foreign trading partners about the states' use of the worldwide unitary method of taxation. While the states and the federal government both recognized unitary as being pre-eminently a state tax issue, involvement of the federal government was deemed essential because of the issue's clear international implications.

To address this issue, the Federal Working Group on Unitary Taxation was formed in 1983 under then Secretary of Treasury Donald Regan. The Working Group, despite lively debate and negotiation, failed to arrive at a consensus agreement. An understanding, however, was reached on two critical elements: (1) the federal government would provide assistance to states modifying their methods of taxing multinationals; and (2) every state, particularly California, would seek legislation responsive to the concerns of our foreign trading partners.

In 1986 and 1988 I signed legislation that largely addressed these concerns on a prospective basis. Unfortunately, the federal government has not fully delivered its promised assistance.

We now find, in spite of positive action by the states, an expansion of unprecedented federal involvement in state tax issues. The Justice Department participated directly through the filing in September 1988 of an amicus curiae brief with the California Court of Appeal in *Barclays Bank International* v. *Franchise Tax Board* and indirectly by writing letters to plaintiff's counsel in *Colgate-Palmolive Co.* v. *Franchise Tax Board*.

The brief and letters of the prior administration are behind us. I am concerned, however, that the federal government may persist in testing the fragile bonds of federalism, and I respectfully request that the Department of Treasury cease further involvement in these state tax matters.

Thank you for your consideration of these matters.

Most cordially,

/s/ George
GEORGE DEUKMEJIAN

jw

[Attached to Colgate's Reply to the Answer to the First Petition for Review to the California Supreme Court]

DEPARTMENT OF THE TREASURY
Washington

[LOGO]

Assistant Secretary

Mr. Mark S. Cahoon
Executive Director
Committee on State Taxation
122 C St. N.W., Suite 330
Washington, D.C. 20001

Dear Mr. Cahoon:

Thank you for your letter of August 26 regarding worldwide unitary taxation. Secretary Brady asked me to respond to your letter because it concerns an issue of tax policy.

As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations. The Treasury Department has testified before Congress that treaty-based limitations on unitary worldwide apportionment are "the least desirable of possible alternatives" (i.e., state or federal legislation) precisely because they would benefit foreign-parent multinationals but not domestic-parent multinationals and thus not "satisfy the principle of ensuring competitive balance among similarly situated businesses." (Cf. Testimony of J. Roger Mentz, Treasury Assistant Secretary (Tax Policy), before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, September 29, 1986, page 3.) Our position has not changed.

We continue to follow this matter with great interest. We are consulting with the Departments of Justice and State, and we will take action when it appears appropriate.

Thank you for your interest in this matter.

Sincerely,

/s/ Kenneth W. Gideon
KENNETH W. GIDEON
Assistant Secretary
(Tax Policy)

[Attached to Colgate's Opening Brief on the Merits in the California Supreme Court]

DEPARTMENT OF THE TREASURY
Washington

[LOGO]

Assistant Secretary

Mr. Jerry J. Jasinowski
President
National Association of Manufacturers
1331 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Dear Mr. Jasinowski:

Thank you for your letter of October 7 to Secretary Brady regarding unitary tax and the Colgate-Palmolive case in California. It has been forwarded to me because it involves an issue of tax policy.

As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations. The Treasury Department has testified before Congress that treaty-based limitations on unitary worldwide apportionment are "the least desirable of possible alternatives" (*i.e.*, state or federal legislation) precisely because they would benefit foreign-parent multinationals but not domestic-parent multinationals and thus not "satisfy the principle of ensuring competitive balance among similarly situated businesses." (*Cf.* Testimony of J. Roger Mentz, Treasury Assistant Secretary (Tax Policy), before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, September 29, 1986, page 3.) Our position has not changed.

Colgate-Palmolive filed a Petition for Review in the Supreme Court of California on September 30, 1991.

This Petition makes very effective use of Treasury's opposition to the use of worldwide unitary tax by the states, as expressed in Secretary Brady's letter of September 13 to Mr. Rueben Mark. Therefore, the Supreme Court of California is now well aware of our position, which has been clear and consistent. We see no reason at this point to submit a brief that would merely repeat the arguments made in the Petition.

Please be assured that we are following this litigation closely. We will coordinate with the Departments of Justice and State when it appears that further action is warranted.

Sincerely,

/s/ Kenneth W. Gideon
KENNETH W. GIDEON
Assistant Secretary
(Tax Policy)

[Attached to Colgate's Opening Brief on the Merits in the California Supreme Court]

MICHAEL GRYLLS, MP

[LOGO]

HOUSE OF COMMONS
London SWIA 0AA

23rd October 1991.

US Secretary Nicholas F. Brady,
Department of the Treasury,
1500 Pennsylvania Avenue, N.W.,
Washington DC 20220,
United States of America.

Dear Senator Brady:

As you know, I have been long concerned about the effect of the unitary taxation method employed by some states of the United States on the worldwide operations of multinational companies. This concern, shared by the overwhelming majority of my colleagues in the House of Commons, resulted in the retaliatory legislation of our 1985 Finance Bill. Although several states have changed their unitary tax policy for multinational companies, others have continued with the policy that is not in the best interests of international trade and investment. I know that this view is shared not only by the United Kingdom and the other non United States trading partners, but by the United States Administration itself.

My colleagues and I appreciate your continuing efforts in support of the Barclays Bank case which is challenging the constitutionality of the Californian tax in the Californian courts. There is an additional opportunity to limit the reach of this taxation method into international waters in the Colgate-Palmolive case also pending in the Californian courts. The Californian taxation method tends to distort trade flows because it implicates investment decisions well beyond the boundaries of the United States. Although the tax method has greater effect on foreign investments into the United States since United States companies do not face this unfair tax in the UK or in the other countries which are trading partners of the United States, concern arises also as to the effect on outbound investments. Measures which distort trade flows have been strongly criticised in the current GATT Uruguay round of negotiations, not the least by the United States.

For reasons outlined, I would strongly urge your department to intervene in the Colgate-Palmolive case by insuring that an amicus brief is filed before the time limit expires at the end of October so that the full international implications of the case can be brought to the attention of the California Supreme Court. I am sending a copy of this letter to the United States Department of Justice.

Yours Sincerely

/s/ Michael Grylls

Supreme Court, U.S.
FILED
DEC 15 1993
OFFICE OF THE CLERK

No. 92-1839

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On ~~Petition for a~~ Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF PETITIONER

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
FRANKLIN C. LATCHAM
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

1. Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant Commerce Clause, may be found in congressional silence.

2. Whether worldwide combined reporting as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the Foreign Commerce Clause.

RULE 29.1 STATEMENT

There are no changes to the Rule 29.1 Statement since the Supplemental Brief of Petitioner was filed with this Court on October 18, 1993.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

No. 92-1839

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF PETITIONER

OPINIONS BELOW

The opinion of the Court of Appeal of California (Pet. App. B at 2a-26a)[1] is reported at 10 Cal. App. 4th 1768, 13 Cal. Rptr. 2d 761 (3d Dist. 1992). An earlier opinion of the Court of Appeal of California in the same case (Pet. App. E at 29a-73a) was reported at 233 Cal. App. 3d 855, 284 Cal. Rptr. 780 (3d Dist. 1991). The

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[1] References to the appendix to the petition for certiorari are denominated "Pet. App." followed by a letter assigned to each item and a page reference. References to the joint appendix accompanying this brief are denominated "J.A." followed by a page reference. References to the appendix to the petition for certiorari in the companion case of *Barclays Bank PLC v. Franchise Tax Bd.*, No. 92-1384, are denominated "*Barclays* Pet. App." followed by a letter assigned to each item and a page reference. References to the joint appendix accompanying the brief of petitioner in *Barclays* are denominated "*Barclays* J.A." followed by a page reference.

opinion of the Superior Court of California (Pet. App. F at 74a-103a) is unreported.

JURISDICTION

The judgment of the Court of Appeal of California, Third Appellate District, was entered on November 20, 1992. Pet. App. B at 26a. The Supreme Court of California denied review on February 18, 1993. Pet. App. A at 1a. The petition for certiorari was filed on May 19, 1993, and was granted on November 1, 1993. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a) (1988).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the Constitution, U.S. Const., art. I, § 8, cl. 3, provides: "The Congress shall have power . . . [t]o regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Section 25101 of the California Revenue and Taxation Code, Cal. Rev. & Tax. Code § 25101 (West 1992), which was in effect for the years at issue, provides: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120)."

STATEMENT

This case, like the companion case of *Barclays Bank PLC v. Franchise Tax Bd.*, No. 92-1384, raises the question whether the Foreign Commerce Clause precludes a state from requiring a multinational group of affiliated corporations to report its income on a worldwide combined basis. The petitioner in this case, Colgate-Palmolive Company, raises the question in the context of a group of foreign and domestic corporations with a domestic parent (a U.S.-based multinational group). The petitioner in *Barclays* raises the question in the context of a group

of foreign and domestic corporations with a foreign parent (a foreign-based multinational group).

Both *Colgate* and *Barclays* raise several issues in common. Both cases require the Court to determine whether Congress, by remaining silent, may be taken to have consented to the states' use of worldwide combined reporting—a determination that, if affirmative, would obviate any inquiry into the constitutionality of worldwide combined reporting under the negative implications of the Foreign Commerce Clause. If the Court finds that congressional silence does not constitute consent, both *Colgate* and *Barclays* require the Court to determine whether worldwide combined reporting frustrates federal foreign policy in violation of the Foreign Commerce Clause.

Colgate and *Barclays* each, however, raise several issues that are not common to both cases. If the Court finds in *Barclays* that the Foreign Commerce Clause affords a *foreign*-based multinational group protection from a state's requirement of worldwide combined reporting for reasons that do not, by their own force, apply to a *U.S.*-based multinational group, *Colgate* raises two additional issues. First, *Colgate* raises the issue whether foreign policy concerns of "competitive balance" independently compel the conclusion that the Foreign Commerce Clause protects a U.S.-based multinational group from a state's requirement of worldwide combined reporting. Second, even if the Court were to find that Colgate did not have an independent policy-based Foreign Commerce Clause grievance against California's taxing method, *Colgate* raises the issue whether a U.S.-based multinational group engaged in foreign commerce is nonetheless entitled to the same protection that is afforded a foreign-based multinational group engaged in such commerce, to avoid discrimination against one form of foreign commerce in favor of another. *Barclays* also raises issues that are not raised by *Colgate* regarding the administrative burdens that worldwide unitary combination imposes on a foreign-based multinational group.

The underlying facts regarding the questions raised by *Colgate* in its petition were stipulated and are not in dispute.

A. Colgate-Palmolive Company's Business

Colgate-Palmolive Company is a Delaware corporation with its corporate headquarters in New York. During the years in question (1970-73), Colgate-Palmolive Company and its subsidiaries doing business in the United States (hereinafter collectively "Colgate") were engaged principally in the manufacture and distribution of household and personal hygiene products. Colgate's manufacturing and distribution operations extended throughout the United States, including California. In addition to its United States operations, Colgate owned approximately 75 subsidiaries that operated in 53 foreign countries (hereinafter Colgate's "foreign subsidiaries" or "foreign operations"). Joint Stipulation, *Colgate-Palmolive Co. v. Franchise Tax Bd.*, No. 319715 (Cal. Super. Ct.), ¶ 8 (J.A. 5).[2] These foreign subsidiaries, which were likewise engaged in the manufacture and distribution of household and personal hygiene products, operated *exclusively* in foreign countries. They conducted no business in California or in any other state.

B. The Separate Accounting Method

The United States, along with virtually all other nations in the world, uses the "arm's-length" or "separate accounting" method to assign the income of a multinational group of corporations among the different jurisdictions in which it operates.[3] Under this method, the various members of a multinational enterprise are viewed as separate from one another, and the income of any particular member of the group is determined on the basis of the internal accounting records of that member. Affiliates are required to report intercompany transactions on an arm's-length

[2] All subsequent references to the joint stipulation in this case are denominated "Stip." followed by a paragraph reference.

[3] *See* I.R.C. § 482 (1986); *see also* Treas. Reg. § 1.482 (1988).

basis, as if dealing with unrelated entities in the marketplace.

Separate accounting is the method uniformly adopted in tax treaties between the United States and foreign nations, as well as the standard that the United States has adopted in its internal tax laws. *See* income tax treaties cited in *Barclays* J.A. A-26–A-31; *see also* Pet. App. A at 5a. Accordingly, separate accounting is the method by which the United States and foreign countries determined the income of Colgate and its foreign subsidiaries. Testimony of Gerald Gibian, Reporter's Transcript at 311.

C. California's Worldwide Combined Reporting Method of Taxation

In contrast to the arm's-length, separate accounting method employed by the United States and its foreign trading partners, the worldwide combined reporting method employed by California during the years at issue [4]

[4] In response to widespread opposition to its worldwide combined reporting requirement (*see infra* pp. 6-10), California subsequently enacted legislation modifying the requirement that taxpayers file income tax returns on a worldwide combined basis. Specifically, in 1986, California enacted legislation to take effect on January 1, 1988, permitting a corporate taxpayer engaged in a worldwide unitary business to elect to compute its California franchise tax liability generally on the basis of its United States, as opposed to its worldwide, operations. *See* Cal. Rev. & Tax. Code § 25110 (West 1992). Subsequently, in 1993, California enacted Senate Bill 671 (Oct. 6, 1993) which modifies this "water's-edge" election in three principal respects. Cal. S.B. 671, 1993-94 Reg. Sess. (Oct. 6, 1993). First, the legislation removes the fee that corporations were required to pay under pre-existing law if they wished to limit combined reporting of their income to a "water's-edge" group. *Id.* §§ 24, 26. Second, the legislation removes the authority the Franchise Tax Board possessed under certain circumstances to disregard a corporation's water's-edge election and to require it to file on a worldwide combined basis. *Id.* §§ 16, 23. Third, the legislation eliminates the Domestic Disclosure Spreadsheet, which corporations making a water's-edge election were required to file under pre-existing law, and requires instead that certain large corporations file a list of 20 percent-or-more owned

treats as a single enterprise all of the worldwide affiliates of a multinational group that are engaged in a unitary business. The resulting worldwide income is divided between California and the rest of the world on the basis of a three-factor apportionment formula of property, payroll, and sales. During the years at issue, California determined Colgate's California income by this method: Colgate's California property, payroll, and sales were divided, respectively, by the worldwide property, payroll, and sales of Colgate and its foreign subsidiaries; these three fractions were averaged to produce Colgate's California apportionment percentage; and the apportionment percentage was then applied to the worldwide combined taxable income of Colgate and its foreign subsidiaries to produce Colgate's California taxable income. Pet. App. B at 4a-7a.

D. Opposition to California's Worldwide Combined Reporting Method of Taxation

Since its inception, the worldwide combined reporting method of taxation has been the focus of steadily increasing national and international opposition because of its disregard of the established international norm of tax accounting.[5]

On the international front, foreign governments have repeatedly and forcefully protested California's use of the taxing method through both formal and informal diplomatic channels. *See e.g. Barclays* J.A. A-68–A-138. These protestations have included diplomatic notes from virtually every developed country in the world, including the United Kingdom, Japan, Canada, and Belgium. *See, e.g., id.*

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affiliates. *Id.* § 13. Senate Bill 671 applies only to tax years beginning on or after January 1, 1994.

[5] *See, e.g.*, Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 33 (1977) (statement of Laurence N. Woodworth, former Assistant Secretary of the Treasury (Tax Policy)); Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 3, 7 (1980) (statement of David C. Lubick, former Assistant Secretary of the Treasury (Tax Policy)).

Moreover, California's use of worldwide combined reporting has become a material stumbling block in U.S. treaty negotiations. *See, e.g.*, diplomatic note from the British Embassy to the Department of State, Washington, D.C., dated March 25, 1980, regarding the difficulties that states' use of worldwide combined reporting created in the negotiation of the U.S.-U.K. tax treaty (*Barclays* J.A. A-96–A-99). Indeed, the continued use of worldwide combined reporting prompted the United Kingdom in 1985 to enact retaliatory legislation which gives the United Kingdom the authority to deny the shareholders' tax credit (a credit that the United Kingdom gives on dividends paid by U.K. subsidiaries to their U.S. parents) to U.S. parents with a presence in states that use worldwide combined reporting.[6] As a result of Senate Bill 671, recently enacted by California to modify the state's taxation of a multinational group of corporations (*see supra* p. 5, n.4), the United Kingdom withdrew its recent threat to implement the retaliatory legislation; however, it remains statutorily available to the United Kingdom. Colgate would be directly subject to this retaliatory legislation, if it is ever enforced.

On the domestic front, the Federal Government has pursued a policy opposing states' use of worldwide combined reporting, largely because of the impact of that method of taxation upon relations with foreign nations. At least until 1983, however, that policy had not been expressed with great clarity. Accordingly, in 1983, this Court, observing that the Federal Government had not issued an explicit statement indicating that worldwide combined reporting frustrated federal foreign policy, sustained the application of California's taxing method. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 194-96 (1983).

Following *Container*, the President of the United States acted to avoid perpetuation of the ambiguity that laid the

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[6] Section 54 and Schedule 13 to the Finance Act of 1985, reenacted as Sections 812-815 of the Income and Corporations Taxes Act, 1988.

predicate for that decision. Specifically, in September 1983, just three months after *Container*, the President formed the Worldwide Unitary Taxation Group, which issued its final report to the President on August 31, 1984. Based on this report, the President issued a statement on November 8, 1985, instructing the Secretary of the Treasury to pursue through legislation, and the Attorney General to pursue in appropriate cases in litigation, the federal policy that multinationals be taxed by states only on income derived from the territory of the United States. *See* Press Statement of President Reagan (November 8, 1985) (J.A. 7-8).

Subsequent to this statement, Secretary of State George Shultz wrote to the Governor of California, George Deukmejian, on January 30, 1986, to explain the foreign policy concerns that prompted the Federal Government's action. Secretary Shultz explained those foreign policy concerns, in part, as follows:

> The United States has advocated and adopted the position that the "arm's-length" adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed. This view is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. . . . Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

Letter from Secretary of State George Shultz to George Deukmejian, Governor of California (January 30, 1986) (J.A. 9-10). *See also* letter from Secretary of the Treasury James A. Baker III to Senator Bob Packwood, Chairman of the Senate Finance Committee (March 5, 1986), reiterating the inconsistency of worldwide combined reporting with United States foreign policy (J.A. 13-23).

Moreover, consistent with President Reagan's mandate to the Attorney General to oppose worldwide combined

reporting in appropriate cases in litigation, the Federal Government has issued statements for use in the litigation of this very case. In response to a specific request from Colgate that the Federal Government repeat its position on worldwide combined reporting and make that position explicit in the context of domestic-based multinational groups (*see* J.A. 31-34), the Federal Government declared:

> As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations.

Letter from Secretary of the Treasury Nicholas Brady to Reuben Mark, Chairman, President, and Chief Executive Officer of Colgate (September 13, 1991) (J.A. 35).

As further evidence of worldwide combined reporting's incompatibility with federal foreign policy, Secretary Brady attached correspondence from the Member States of the European Community to his letter to Colgate's chairman. *See* J.A. 37-42. Moreover, Secretary Brady expressed the Federal Government's view that eliminating worldwide combined reporting as applied to foreign-based taxpayers only was the " 'least desirable of possible alternatives' " (J.A. 35) because such a solution would not " 'satisfy the principle of ensuring competitive balance among similarly situated businesses.' " J.A. 36 (citing testimony of J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy), before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, Sept. 29, 1986, p. 3). *See also* letter from J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy), to George Deukmejian, Governor of California (April 8, 1987) (J.A. 24-27).

Both national and international hostility towards worldwide combined reporting has continued to this day. On October 7, 1993, the U.S. Government expressed its views to this Court that "state use of worldwide combined

reporting was 'at odds with the position of the United States and has become a source of conflict with foreign states.'" S.G. Br. at 4.[7] Moreover, the Solicitor General acknowledged that the "analysis and holdings of the California Supreme Court" upholding worldwide combined reporting "are subject to serious question." *Id.* at 8. Similarly, on September 23, 1993, the Member States of the European Community and the Commission of the European Communities expressed to the U.S. Government "their strong opposition to worldwide unitary taxation." *See* Demarche from the Member States of the European Community and the Commission of the European Communities, dated September 23, 1993, *reprinted in* the Appendix to the Supplemental Brief of Petitioner in this case, filed with the Court on October 18, 1993.

E. The Tax Assessment

Colgate timely filed California franchise tax returns for the tax years 1970 through 1973, reporting the income earned from its foreign operations on a separate accounting basis. Stip. ¶ 2 (J.A. 4). The California Franchise Tax Board determined that Colgate's tax should be computed on the basis of worldwide combined reporting. Colgate paid the additional tax owing under the Franchise Tax Board's method of computation and filed claims for refund, which the Board denied. Stip. ¶ 7 (J.A. 5).

F. The Proceedings Below

1. *Superior Court of California*

In April 1984, Colgate filed suit in the Superior Court of California seeking a refund of franchise taxes paid for tax years 1970-73 on the ground, among others, that the Foreign Commerce Clause precluded California from requiring Colgate to report its income to California on a

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[7] All references to the Solicitor General's *amicus* brief filed in connection with Barclays' petition for certiorari in No. 92-1384 are denominated "S.G. Br." followed by a page reference.

worldwide combined basis. After lengthy discovery, a two-week trial was conducted in July, 1988, at which the parties introduced extensive evidence of the Federal Government's policy towards worldwide combined reporting. In April 1989, the court issued its decision, which concluded that the application of California's requirement of worldwide combined reporting to Colgate and its foreign subsidiaries frustrated United States foreign policy, in violation of the negative implications of the Foreign Commerce Clause.

In reaching its conclusion, the trial court rejected the contention of the Franchise Tax Board that Congress had expressly approved of California's method of taxation, thereby rendering dormant Commerce Clause analysis unnecessary. On the contrary, the court found as a factual matter "that the executive branch of the federal government has clearly expressed a federal policy supporting the principle of water's edge taxation of multinational corporations and disapproving the world-wide unitary method . . . and that the legislative branch has not expressed a contrary policy." Pet. App. F at 97a-98a.

Reviewing the facts under the dormant Foreign Commerce Clause criteria first articulated by this Court in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), the trial court found that California's "method of taxation of multinational corporations impermissibly interferes with the federal government's power to conduct foreign commerce and is thus unconstitutional." Pet. App. F at 98a. Moreover, the court found that federal policy was the same whether the worldwide combined reporting method was applied to U.S.-based multinational groups, such as Colgate, or to foreign-based multinational groups (such as the petitioner in *Barclays*). As the court observed, "[t]he condemnation of the world-wide unitary method applies to all instrumentalities of foreign commerce, not just foreign based corporate groups." Pet. App. F at 90a.

In arriving at its conclusion, the court found that this case differed dramatically in its factual posture from *Container*. In *Container*, this Court addressed the same issue that Colgate raises here—the constitutionality of worldwide combined reporting—but found that there was no evidence of a clear statement by the Federal Government regarding the impact of worldwide combined reporting on federal foreign policy. *Container*, 463 U.S. at 195 n.33. Here, by contrast, the trial court found that the evidence which was lacking in *Container* had been supplied by the Executive Branch and introduced by Colgate. Pet. App. F at 90a. "On this record," the court concluded,

> it is impossible to say that the executive branch of the federal government has not spoken clearly. It is the policy of the United States, speaking through the executive branch, that the water's edge system be followed and the unitary method discarded.

Id. at 91a.

2. *Court of Appeal of California (First Decision)*

In August 1991, the Court of Appeal reversed. The Court of Appeal agreed with the trial court that Congress had not consented to worldwide combined reporting, which therefore required the court to consider the validity of worldwide combined reporting under the dormant Foreign Commerce Clause. The Court of Appeal had already held that the dormant Foreign Commerce Clause prohibited worldwide combined reporting as applied to a foreign-based multinational group in its decision in *Barclays*. *Barclays* Pet. App. at B-2. The court nevertheless held that the Foreign Commerce Clause would not bar worldwide combined reporting as applied to Colgate without a more explicit statement of federal hostility towards worldwide combined reporting in the context of a U.S.-based multinational group. The Court of Appeal justified its conclusion on the basis that the Federal Government had been notified about the case by counsel for Colgate and yet "the executive branch has done nothing here to make its position known" in the case. Pet. App. E at 57a.

3. *Supreme Court of California (First Petition for Review)*

Colgate's petition for review to the Supreme Court of California was based largely on statements by the Executive Branch condemning worldwide combined reporting as applied to Colgate. These statements, some of which were released after the Court of Appeal's decision, were intended to meet that court's objection that previous statements of the Executive Branch regarding its opposition to worldwide combined reporting were not specifically directed to a U.S.-based multinational group. The Supreme Court of California granted Colgate's petition for review in November 1991. Pet. App. D at 28a.

In May 1992, however, before this case was set for argument in the Supreme Court of California, the court issued its decision in *Barclays*. *Barclays* Pet. App. at C-1–C-40. Without reaching the question whether the negative implications of the Foreign Commerce Clause precluded the application of worldwide combined reporting to a foreign-based multinational group, the court found that such an inquiry was obviated by the fact that Congress had consented to California's taxing method. The court did not find this consent in any affirmative congressional action. Rather, the court gleaned such consent from what it referred to as "the din of a 'governmental silence'." *Barclays* Pet. App. at C-26. Relying on *Wardair Canada, Inc. v. Florida Dep't of Rev.*, 477 U.S. 1 (1986), the court held that

> recent foreign commerce clause jurisprudence reflects a diminution in the reach of dormant foreign commerce clause analysis in favor of an expanded recognition that, under circumscribed conditions, governmental silence may constitute a ratification of state taxation of foreign commerce, rendering a dormant analysis inapposite.

Barclays Pet. App. at C-4.

In June 1992, the Supreme Court of California transferred this case back to the Court of Appeal "with directions to vacate its decision and to refile the opinion after modification in light of *Barclays Bank International v. Franchise Tax Board* (1992) 2 Cal. 4th 708, 8 Cal. Rptr. 2d 31, 829 P. 2d 279." Pet. App. C at 27a.

4. *Court of Appeal of California (Second Decision)*

In February 1993, the Court of Appeal issued its second decision in this case—the decision that is before this Court for review. The Court of Appeal recognized that the dormant Foreign Commerce Clause analysis which underlay its initial decision rejecting Colgate's Foreign Commerce Clause claim was inappropriate in light of the California Supreme Court's opinion in *Barclays*. Accordingly, despite its earlier conclusion that Congress had not consented to worldwide unitary combination, Pet. App. E at 43a, the Court of Appeal now felt constrained by the California Supreme Court's opinion to revisit the question of congressional consent. The court observed that "there is no distinction between this case and *Barclays*" (Pet. App. B at 18a) for purposes of determining whether there was congressional consent, since the factors on which the California Supreme Court relied in *Barclays* to find such consent were equally present in this case. *Id.* The Court of Appeal therefore found itself "obligated to adopt the analysis in *Barclays* regarding *Wardair*'s applicability" (*id.*) and held that Congress had consented to the states' application of worldwide combined reporting to domestic-based, as well as to foreign-based, multinational groups.

5. *Supreme Court of California (Second Petition for Review)*

In February 1993, the Supreme Court of California denied Colgate's petition for review of the revised opinion of the Court of Appeal. Pet. App. A at 1a.

SUMMARY OF ARGUMENT

1. When Congress exercises its power under the Commerce Clause to consent to a state law, it eliminates any question of the validity of that law under the dormant Commerce Clause, even if the state law imposes substantial burdens on interstate or foreign commerce. Recognizing the considerable consequences that flow from a finding of congressional consent, this Court has consistently required that Congress manifest its consent to state law under the Commerce Clause through unambiguous affirmative action. *See, e.g., Wyoming v. Oklahoma,* 112 S. Ct. 789, 802 (1992); *Maine v. Taylor,* 477 U.S. 131, 138-39 (1986); *Sporhase v. Nebraska ex rel. Douglas,* 458 U.S. 941, 960 (1982).

The California Supreme Court, whose decision in *Barclays* dictated the decision below on the congressional consent issue, ignored this settled body of case law in finding congressional consent to California's use of worldwide combined reporting not in unambiguous affirmative action, but rather in "the din of a 'governmental silence.' " *Barclays* Pet. App. at C-26. In justifying its novel approach to the congressional consent issue, the court relied almost exclusively on this Court's decision in *Wardair,* which, in the state court's view, represented a "retrenchment" in the scope of this Court's dormant Commerce Clause jurisprudence. *Id.* at C-24.

The state court's conclusion that congressional silence can form the basis for congressional consent, however, cannot be squared with *Wardair* or decisions preceding or following it. Indeed, *Wardair* itself found consent on the ground that "the Federal Government has not remained silent" but rather "has affirmatively decided to permit" the state tax there at issue. *Wardair,* 477 U.S. at 12. Moreover, the California court's view that congressional silence can signify consent under the Commerce Clause undermines the free trade purposes of the Clause. If congressional inaction—as well as congressional action—is recognized as a legitimate basis for validating state laws that are

otherwise unconstitutional under the Commerce Clause, then the scope of Commerce Clause protection from burdensome state laws will be severely narrowed, if not eliminated altogether.

Even assuming that congressional inaction could, in some circumstances, lay the foundation for a finding of congressional consent to state law, the inaction of Congress in this case is inconsistent with any plausible view of consent and bears no resemblance to the factual basis that led the Court to find consent in *Wardair*. Whereas the Court in *Wardair* found consent in a series of international agreements that specifically considered the state taxation at issue, the California Supreme Court found consent by implication in a series of congressional inactions. Four of the five congressional inactions involve no mention of the states' use of worldwide combined reporting. The single inaction that even concerns the matter here at issue is a failure to obtain the necessary two-thirds vote to ratify a treaty containing a provision prohibiting the states' use of worldwide combined reporting. A majority of Senators, however, voted to support the provision, negating any inference of consent from the failure to act.

Finally, each of the factors on which the California Supreme Court relied as a basis for congressional consent was before this Court in *Container*. Yet, in *Container*, the Court did not find congressional consent and undertook dormant Commerce Clause analysis when considering the constitutionality of California's taxing method.

2. Under the negative implications of the Foreign Commerce Clause, a state tax cannot survive scrutiny if the tax prevents the Federal Government from " 'speaking with one voice when regulating commercial relations with foreign governments.' " *Japan Line*, 441 U.S. at 451. A state tax will violate the "one voice" standard either if it violates "a clear federal directive" or if it "implicates foreign policy issues that must be left to the Federal Govern-

ment." *Container*, 463 U.S. at 194. California's worldwide combined reporting regime fails both these tests.

The Federal Government has issued a "clear federal directive" in this very case that California's worldwide combined reporting method as applied to Colgate is contrary to United States foreign policy. Executive Branch statements in this case, and in other contexts, unequivocally declare that the United States opposes the use of worldwide combined reporting as applied to a U.S.-based multinational group like Colgate, just as it is opposed to the use of worldwide combined reporting as applied to a foreign-based multinational group like Barclays. The Federal Government has thus provided the evidence of the United States' unmitigated hostility to worldwide combined reporting that was missing at the time the Court decided *Container* and whose absence led the Court to sustain the application of worldwide combined reporting in that case.

The Federal Government's statements likewise make it clear that worldwide combined reporting as applied to a U.S.-based multinational group "implicates foreign policy issues which must be left to the Federal Government." *Id.* Executive Branch statements have expressed the Federal Government's position that the states' use of worldwide combined reporting constitutes an impermissible interference with the conduct of the nation's foreign affairs.

Even if, contrary to Colgate's view, the Court were to find that worldwide combined reporting is invalid as applied to foreign-based multinationals in *Barclays* for reasons that do not, by their own force, apply to U.S.-based multinational groups, there are two additional reasons why California is nonetheless precluded from requiring Colgate to report on a worldwide combined basis. Foreign policy considerations of "competitive balance" independently compel the conclusion that the Foreign Commerce Clause protects a U.S.-based multinational group from worldwide combined reporting. The Federal Gov-

ernment has consistently embraced the view that the maintenance of competitive balance for domestic corporations vis-a-vis foreign corporations is a central tenet of United States foreign policy. Permitting California to apply worldwide combined reporting to U.S.-based multinational groups but not to foreign-based multinational groups would violate that policy.

Basic principles of Commerce Clause analysis similarly require that a U.S.-based multinational group like Colgate be accorded the same treatment accorded foreign-based multinationals, wholly apart from foreign-policy concerns of "competitive balance." The Commerce Clause forbids the states from preferring one form of protected commerce over another. *Boston Stock Exchange v. State Tax Comm'n,* 429 U.S. 318 (1977). If California were permitted to apply worldwide combined reporting to a U.S.-based multinational group like Colgate, which is engaged in foreign commerce, but not to a foreign-based multinational group like Barclays, which is likewise engaged in foreign commerce, the resulting preference for foreign-based multinational groups would tilt the level playing field against one form of foreign commerce and frustrate the free trade considerations underlying the Commerce Clause.

ARGUMENT

I. CONGRESS HAS NOT CONSENTED TO CALIFORNIA'S USE OF WORLDWIDE COMBINED REPORTING

The decision of the court below that Congress has consented to worldwide combined reporting—a decision contrary to the court's initial view of this question (*see* Pet. App. E at 43a)—was compelled by the California Supreme Court's opinion in *Barclays.* Indeed, had the court below not felt "obligated" (Pet. App. B at 18a) to follow *Barclays,* it would no doubt have adhered to its opinion that one cannot "presume that Congress has affirmatively stated its position through silence" (Pet. App. E at 45a) and therefore that Congress had not consented to worldwide combined reporting. As we demonstrate below, there is no basis in law or policy for the California Supreme Court's novel approach to the question of congressional consent, nor is there a basis, under any plausible standard, for that court's conclusion that Congress has consented to worldwide combined reporting.

A. In Recognizing Congress' Power to Consent to State Laws That Would Otherwise Be Unconstitutional Under the Dormant Commerce Clause, This Court Has Equated Consent with Unambiguous Affirmative Congressional Action

The appropriate standard for determining when Congress has consented to state law under the Commerce Clause is grounded in the underlying principle that accords congressional consent its crucial constitutional function in this domain. The principle was first articulated a century ago in *In re Rahrer,* 140 U.S. 545 (1891), and given its definitive modern exposition in *Prudential Ins. Co. v. Benjamin,* 328 U.S. 408 (1946).

In *Prudential,* the Court considered a challenge under the negative implications of the Commerce Clause to a South Carolina tax on insurance companies that allegedly discriminated against interstate commerce. Congress had

provided in the McCarran Act, however, that "taxation by the several States of the business of insurance is in the public interest, and that silence on the part of Congress shall not be construed to impose any barrier to the . . . taxation of such business. . . ." 15 U.S.C. § 1011 (1988). In addressing the question whether its dormant Commerce Clause cases had any bearing on the taxpayer's claim, the Court first observed that "[t]hose cases . . . presented no question of the validity of such a tax where Congress had taken *affirmative action* consenting to it. . . ." *Prudential,* 328 U.S. at 421 (emphasis supplied).

Because the taxpayer argued that the Commerce Clause, by its own force, nevertheless limited "Congress' permissible action in this respect" (*Prudential,* 328 U.S. at 422), the Court proceeded to address the merits of the question. The Court put the question this way: "[I]f the commerce clause, 'by its own force' forbids discriminatory state taxation, or other measures, how is it that Congress *by expressly consenting* can give that action validity?" *Id.* at 426 (emphasis supplied). The answer was easy. When Congress has acted under its commerce power, whether to preempt or to consent to a state law, any question of the validity of the state law under the dormant Commerce Clause disappears. Indeed, "whenever Congress' judgment has been *uttered affirmatively* to contradict the Court's previously expressed view that specific action taken by the states in Congress' silence was forbidden by the commerce clause, this body has accommodated its previous judgment to Congress' *expressed approval.*" *Id.* at 425 (emphasis supplied). Since Congress in the McCarran Act had "*expressly stated* its intent and policy" (*id.* at 427) (emphasis supplied) regarding the states' freedom to tax the insurance industry, the Court was "not required to determine whether South Carolina's tax would be valid in the dormancy of Congress' power." *Id.*

The requirement that Congress' consent to state laws under the Commerce Clause be reflected in Congress'

affirmative action is necessitated by the profound consequences of finding such consent. As the Court noted in *Prudential,* because Congress has plenary power over the channels of interstate commerce, "Congress may keep the way open, confine it broadly or closely, or close it entirely" (*Prudential,* 328 U.S. at 434), subject only to the limitations that the Constitution imposes on Congress' own power. This includes, of course, the power to authorize state laws that discriminate against or otherwise burden interstate commerce, laws that would be struck down in the absence of congressional action consenting to them. *Id.* By clearly indicating that congressional consent was a function of affirmative action by Congress, the Court in *Prudential* protected the values underlying the Commerce Clause from erosion through findings of implied congressional consent, recognizing that to expose interstate or foreign commerce to burdensome state legislation without the clearest signal from Congress would undermine our constitutional scheme. "Absent 'a clear expression of approval by Congress,' any relaxation in the restrictions on state power otherwise imposed by the Commerce Clause unacceptably increases 'the risk that unrepresented interests will be adversely affected by restraints on commerce.' " *Maine v. Taylor,* 477 U.S. at 139.

Because Congress' consent to state law under the Commerce Clause completely removes that law from judicial scrutiny under the negative Commerce Clause, the Court, faithful to the teachings of *Prudential,* has properly insisted that Congress manifest its consent to state law through unambiguous affirmative action. Thus, the Court has repeatedly stressed that "[a]n unambiguous indication of congressional intent is required before a federal statute will be read to authorize otherwise invalid state legislation" and to provide an "exemption from Commerce Clause scrutiny." *Maine v. Taylor,* 477 U.S. at 139; *see also Wyoming v. Oklahoma,* 112 S. Ct. at 802 ("Congress must manifest its unambiguous intent before a federal statute will be read to permit or approve . . . a violation of the Commerce Clause"); *South-Central Timber Dev.,*

Inc. v. Wunnicke, 467 U.S. 82, 91-92 (1984) (rejecting " 'implicit approval' theory" of congressional consent and reaffirming "[a] rule requiring a clear expression of approval by Congress"); *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. at 960 ("[i]n the instances in which we have found such [congressional] consent, Congress' 'intent and policy' to sustain state legislation from attack under the Commerce Clause" was " 'expressly stated' "); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 343 (1982) ("when Congress has not 'expressly stated its intent and policy' to sustain state legislation from attack under the Commerce Clause, . . . we have no authority to rewrite its legislation based on mere speculation as to what Congress 'probably had in mind' ").

B. The California Supreme Court's Novel Approach to Ascertaining Congressional Consent Under the Commerce Clause Is Irreconcilable with the Decisions of This Court

Despite the large and settled body of case law bearing on congressional consent to state law under the Commerce Clause, the California Supreme Court virtually ignored it in holding that congressional consent could be found in "a species of governmental *silence* that forecloses resort to a dormant foreign commerce clause analysis." *Barclays* Pet. App. at C-21 (emphasis in original). Indeed, the lower court's view rests entirely on its misreading of one case—*Wardair*, 477 U.S. 1. *Wardair* involved the imposition of a Florida sales tax on aviation fuel purchased in Florida by a foreign air carrier for use in international flights. The carrier challenged the tax on two theories: first, it was preempted by federal legislation; second, it was barred by the dormant Commerce Clause.

The Court rejected the preemption argument on the ground that Congress had expressly permitted the states to impose "sales or use taxes on the sale of goods or services" (Federal Aviation Act of 1958, § 1113(b), 49 U.S.C. App. § 1513), which included airline fuel. *Wardair*,

477 U.S. at 6-7. Such an affirmative statement by Congress might itself have been deemed sufficient to constitute consent to the state law, thereby precluding any further inquiry into the matter under the negative implications of the Commerce Clause. The Court nevertheless felt compelled to go further in responding to the taxpayer's dormant Commerce Clause argument because the Court felt Congress may not have expressly considered the imposition of such taxes on *foreign* air carriers in enacting Section 1113 of the Federal Aviation Act, even though that section did not by its terms distinguish between foreign and domestic carriers. *Wardair*, 477 U.S. at 7. Thus, consistent with its precedents addressing congressional consent to state law (*see supra* pp. 21-22), the Court adopted an extremely high standard for finding express approval of a state tax, requiring a clear indication that Congress had intentionally taken legislative action manifesting consent to the tax.

In finding unambiguous affirmative congressional action, the Court relied on a series of international agreements which "demonstrate that the Federal Government has *affirmatively acted*, rather than remained silent, with respect to the power of the States to tax aviation fuel." *Wardair*, 477 U.S. at 9 (emphasis supplied). What the international agreements made "abundantly clear" (*id.* at 12) to the Court was that "the Federal Government *has not remained silent* with regard to the question whether the States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel." *Id.* (emphasis supplied). Because the "Federal Government has *affirmatively decided* to permit the States to impose these sales taxes on aviation fuel" (*id.* (emphasis supplied)), and because "it would turn dormant Commerce Clause analysis upside down to apply it where the *Federal Government has acted*" (*id.* (emphasis supplied)), the Court concluded that Congress had consented to the Florida tax and there was no need to consider its validity under the dormant Commerce Clause.

Despite the Court's unequivocal holding in *Wardair* that affirmative congressional action is the touchstone of congressional consent to state law under the Commerce Clause, the California Supreme Court nevertheless found that Congress had consented to California's worldwide combined reporting scheme based on congressional silence and inaction. *See infra* pp. 27-31. The court justified its departure from this Court's precedents on the ground that *Wardair* itself "represents, if not a change of course in the high court's dormant foreign commerce clause jurisprudence, at least a retrenchment in its scope." *Barclays* Pet. App. at C-24. According to the California court, *Wardair* "can be abstracted into a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." *Id.* at C-23. The court read *Wardair* as "establish[ing] an interpretive framework for educing from a compilation of legislative materials a species of governmental *silence* that forecloses resort to a dormant foreign commerce clause analysis." *Id.* at C-21 (emphasis in original).

The California Supreme Court's frontal assault on this Court's criteria for determining when Congress has consented to state law under the Commerce Clause is indefensible. First, as explained above, there is no justification either in constitutional policy or in this Court's precedents for the extraordinary suggestion of the California Supreme Court that Congress' silence constitutes consent under the Commerce Clause. *See supra* pp. 19-22.

Second, even if there are some suggestions in *Wardair* that the "negative implications" (477 U.S. at 10, 12) of affirmative congressional *action* can lay the evidentiary predicate for a finding of congressional consent to state law, these suggestions do not license a state court to base a finding of consent on the negative implications of *inaction*, which is what the California court did here. *See infra* pp. 25-31. The Court in *Wardair* explicitly declared that it was drawing negative inferences from governmental

action—not governmental omission—in finding that Congress had affirmatively consented to the state tax at issue.

Third, the suggestion that *Wardair* "represents, if not a change of course in the high court's dormant foreign commerce clause jurisprudence, at least a retrenchment in its scope" (*Barclays* Pet. App. at C-24) is unfounded. *Wardair* is cut from the same cloth as the Court's earlier decisions involving congressional consent (*see supra* 19-22), as well as its later decisions. *Id.* Indeed, the claim that there has been a "retrenchment" in the Court's Foreign Commerce Clause jurisprudence is belied by the Court's most recent decision in this domain. *See Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev. and Finance*, 112 S. Ct. 2365 (1992) (invalidating Iowa's income tax scheme under established dormant Commerce Clause principles developed prior to *Wardair*).

Finally, the California court's decision frustrates the free trade purposes underlying the Commerce Clause. According to the California court's analysis, "silence" becomes a basis for inferring consent to state law under the Commerce Clause. Yet it is this very "silence" that has for two centuries been the basis for the Court's dormant Commerce Clause jurisprudence. If congressional silence can justify a finding of congressional consent to state laws, then there may well be no room for the dormant Commerce Clause to operate at all. At a minimum, its scope may be substantially narrowed, and courts will have to distinguish between the kinds of "silence" that warrant a dormant Commerce Clause inquiry and those that preclude judicial scrutiny of state law altogether.

C. Even Assuming That Congressional Consent Can, in Some Circumstances, Be Inferred from Congress' Silence, No Such Inference Could Be Drawn in This Case Without Rendering the Concept of Congressional Consent Meaningless

Even assuming that Congress' silence could, in some circumstances, lay the evidentiary foundation for a finding of congressional consent to state law under the Com-

merce Clause, the inaction of Congress in this case is inconsistent with any plausible view of consent and is a far cry from the facts that lay the foundation for finding congressional consent in *Wardair*.

The Court in *Wardair* found recourse to dormant Commerce Clause analysis unnecessary because Congress had "affirmatively acted, rather than remained silent, with respect to the power of the States to tax aviation fuel." *Wardair*, 477 U.S. at 9; *see supra* p. 23. The Court found this affirmative action in three sources: (1) the Chicago Convention on International Civil Aviation entered into by the United States on December 7, 1944; (2) a Resolution adopted November 14, 1966, by the International Civil Aviation Organization, of which the United States is a member; and (3) bilateral agreements concluded between the United States and various foreign countries.

The Chicago Convention specifically considered subnational taxation of aviation fuel and prohibited local taxes on fuel only when the fuel was "on board an aircraft . . . on arrival . . . and retained on board on leaving." Consistent with well-settled principles of statutory construction, *see* 2A Norman J. Singer, *Sutherland Statutory Construction* § 47.23 (5th ed. 1992), this Court found that, by directly addressing the question of state taxation of aviation fuel and specifying which taxes could not be imposed, the Federal Government was thereby consenting to the imposition of other state taxes, including the state tax at issue in that case. *Wardair*, 477 U.S. at 10.

With respect to the 1966 Resolution, on the other hand, even though it endorsed an international scheme to exempt fuel "from all customs and other duties," the Court found that this endorsement did not negate the congressional policy reflected in the 1944 Chicago Convention. The Resolution was found not to be action by the government of the United States but merely the work product of an organization to which the United States belonged.

The Convention established the context within which the Court considered the subsequent bilateral aviation agreements with foreign countries. In light of the Convention and the Resolution, both of which specifically addressed the concern of subnational taxation, the Court found that the express language of the bilateral agreements precluding only national taxes on aviation fuel reflected a conscious decision by the Federal Government to allow the state taxes at issue in the case. The Court therefore concluded that "the Federal Government has affirmatively decided to permit the States to impose these sales taxes on aviation fuel" (*Wardair*, 477 U.S. at 12) and that dormant Commerce Clause analysis was inappropriate.

The affirmative action found to establish consent in *Wardair* stands in stark contrast to the five items of inaction relied on by the California Supreme Court to support the proposition that Congress has consented to states' use of worldwide combined reporting. These five items of inaction were:

1. Failure to consider state taxes in any income tax treaties with foreign nations, except in nondiscrimination clauses;
2. The absence of any provision restricting state taxes of any sort in various model income tax treaties;
3. The absence of restrictions on state taxation in Friendship, Commerce & Navigation ("FCN") treaties to which the United States is a party;
4. The absence of enacted congressional legislation prohibiting or restricting worldwide combined reporting; and
5. Failure to obtain the necessary two-thirds vote to ratify a treaty containing a provision prohibiting use of worldwide combined reporting by the states.

The first three factors relied on by the California Supreme Court neither directly address nor, indeed, even

consider the question of worldwide combined reporting at the subnational level. The treaties, while requiring use of separate accounting at the national level, are silent on the issue of separate accounting at the state level. Yet the California Supreme Court found that "an extensive pattern of executive branch-negotiated diplomatic texts parallels, in our view, Congress's own unwillingness to disallow legislatively the states' application of formula apportionment methods to foreign-controlled multinational taxpayers, and bespeaks a coordinate 'acquiescence'." (*Barclays* Pet. App. at C-34.)

Such a suggestion is absurd. If congressional consent is to retain any meaning, it cannot be held that an expression of a federal preference for one method of taxation (separate accounting) constitutes congressional consent to states' use of another method of taxation (worldwide combined reporting). Indeed, under the California court's analysis, any treaty that regulated federal taxation at the national level, or failed to consider a particular state taxation method, would reflect a conscious congressional decision to allow states to tax in any manner they please. Such a result would render dormant Commerce Clause analysis obsolete. If the Senate ratified a treaty that included a provision specifically prohibiting or permitting a state taxation method, clearly dormant Commerce Clause analysis would be irrelevant; yet, under the California Supreme Court's approach, if that same treaty were silent on the issue of state taxation, that silence would reflect affirmative approval of and consent to any particular taxing method used by the states, thereby also rendering dormant Commerce Clause analysis irrelevant.

The California Supreme Court's finding that these treaties "parallel[] the *Wardair* paradigm" (*Barclays* Pet. App. at C-34) is also inapt. The treaties at issue in this case are vastly different from the bilateral agreements at issue in *Wardair*. In *Wardair*, the specific subject matter encompassing the tax at issue had been addressed in both the Chicago Convention and the Resolution. The subsequent bilateral agreements were therefore entered into in

the context of these foundational documents. The absence of reference to state taxation reflected a congressional policy to leave unchanged the state tax boundaries established by those earlier documents. In contrast, the treaties and other bilateral agreements at issue in this case did not emanate from any congressional understanding on the subject of state taxation of the income of multinational corporations. Rather these treaties were negotiated and entered into in the context of congressional silence on the subject of state taxation of multinationals and therefore no congressional intent can be attributed to the absence of state taxation regulation.

The California Supreme Court asserted that the tax treaties' nondiscrimination clauses applicable to the states demonstrate that state taxation was in fact at issue in these treaties. Again, however, it is hard to see how a general provision precluding states from taxing foreign corporations at a higher rate than domestic corporations implicates the question of states' use of worldwide combined reporting so that the failure to consider that issue in these treaties can be deemed to reflect congressional policy. Moreover, this general reference to state taxation stands in stark contrast to the specific congressional consideration of the particular subnational tax at issue in the Chicago Convention. Surely, if congressional consent is to have any substantive meaning, then a general nondiscrimination provision cannot give rise to a *Wardair* "negative implication."

A similar analysis applies to the claim that the absence of enacted congressional legislation prohibiting worldwide combined reporting reflects Congress' consent to states' use of that method. Failure to enact legislation is clearly not "affirmative action" of the kind that can be considered in any *Wardair*-type analysis.

The only factor that specifically addresses the application of worldwide combined reporting to foreign-based enterprises is the last factor considered by the California Supreme Court. However, this factor provides no more

insight into congressional policy than the prior four. In 1975, the Executive Branch negotiated an income tax treaty [8] with the United Kingdom that contained a provision, article 9(4), which would have prohibited the states' application of worldwide combined reporting to U.K.-based groups. *Barclays* J.A. A-455. Senator Frank Church introduced a "reservation" to article 9(4) in the Senate Foreign Relations Committee which would have effectively removed article 9(4) from the treaty. This Church reservation was defeated 10 to 5 in the Senate Foreign Relations Committee. The reservation was then voted upon on the Senate floor, and, again, defeated 44 to 34. The treaty with article 9(4) included received a favorable vote of 49 to 32, falling only 5 votes short of the required two-thirds vote necessary for ratification of a treaty. Finally, article 9(4) was reserved without a vote and the treaty was ratified with the reservation.

It is from these three majority votes in favor of *prohibiting* states' use of worldwide combined reporting that the California Supreme Court found a congressional policy *permitting* states' use of worldwide combined reporting. Ignoring the majority votes in favor of article 9(4), the California Supreme Court focused its attention on the failure to achieve the two-thirds majority necessary to ratify the treaty with article 9(4) included. It is always dangerous to speculate on the meaning of congressional inaction, as demonstrated by the fact that the congressional debate over article 9(4) focused not on the merits of worldwide combined reporting but rather on the concern of the Senate that the treaty ratification process was not the appropriate forum in which to consider such a curb on states' powers. The more appropriate forum was Congress.[9] Ironically, the *senatorial* failure to ratify the

[8] Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5668, T.I.A.S. 9682 (entered into force Apr. 25, 1980).

[9] *See* 124 Cong. Rec. 18,669 (1978) (remarks of Sen. Matsunaga); *see also* 124 Cong. Rec. 18,416-17 (1978) (remarks of Sen. Church).

treaty is the "action" that the California Supreme Court points to as most clearly showing *congressional* consent to states' use of worldwide combined reporting. Yet in the view of the Senators at least, Congress had not even considered, let alone approved of, worldwide combined reporting.

It is not surprising, therefore, that the California Supreme Court, when reviewing the five factors considered above, heard "the din of a 'governmental silence'." *Barclays* Pet. App. at C-26.[10] What is surprising is that the court found it was a din "that cannot be ignored." *Id.* at C-26.

This Court has, however, found that the five "inactions" could, and should, be ignored. Each of the five items alleged here as indications of congressional consent to use of the worldwide unitary method of taxation existed *prior to* this Court's decision in *Container*. The *Container* decision refers to the income tax treaties in general, the model treaties, the failure of Congress to take action, and the reservation with respect to the U.K. treaty. *See* 463 U.S. at 196-97. The FCN treaties were discussed in the Franchise Tax Board's brief in *Container*, but were not mentioned in the *Container* opinion. Brief for Appellee at 126-29, *Container*. Yet this Court did not find that Congress had consented to the worldwide unitary method of taxation, but rather that dormant Commerce Clause analysis was appropriate. There have been no indications of congressional consent to California's use of worldwide combined reporting that should lead this Court to draw a different conclusion.

[10] "Din" is defined in *Webster's Third New International Dictionary* (1976) as "a loud noise; *esp*: a welter of confused or discordant sounds." *Id.* at 635.

II. WORLDWIDE COMBINED REPORTING AS APPLIED TO A U.S.-BASED MULTINATIONAL GROUP FRUSTRATES FEDERAL FOREIGN POLICY IN VIOLATION OF THE FOREIGN COMMERCE CLAUSE

Once the error of the decision below on the congressional consent issue is corrected, the relevant question becomes: Can worldwide combined reporting as applied to a U.S.-based multinational group survive scrutiny under the negative implications of the Foreign Commerce Clause? There are three reasons why the answer to that question is "no." First, worldwide combined reporting prevents the Federal Government from "speaking with one voice"—a voice that in recent years has clearly articulated its staunch opposition to worldwide combination for foreign-based and U.S.-based multinational groups alike. Second, if worldwide combined reporting is unconstitutional as to foreign-based multinational groups, then foreign policy concerns of "competitive balance" dictate that worldwide combination be found unconstitutional as to U.S.-based multinational groups as well. Third, wholly apart from a foreign policy-based objection to treating foreign-based and U.S.-based multinational groups differently, the Foreign Commerce Clause guarantees U.S.-based multinational groups engaged in foreign commerce the right to treatment equal to that of foreign-based multinational groups engaged in foreign commerce.

A. Worldwide Combined Reporting as Applied to a U.S.-Based Multinational Group Prevents the Federal Government from "Speaking with One Voice"

A state tax cannot survive scrutiny under the Foreign Commerce Clause if the tax would "impair federal uniformity in an area where federal uniformity is essential," *Japan Line*, 441 U.S. at 448, or prevent "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Id.* at 451 (quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976)). In *Container*, this Court established

that a state tax will violate the "one voice" standard if the tax "*either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Container*, 463 U.S. at 194 (emphasis in original).

1. *Worldwide Combined Reporting as Applied to a U.S.-Based Multinational Group Violates "a Clear Federal Directive"*

Under the "clear federal directive" standard, California's worldwide combined reporting regime must be struck down in its application to U.S.-based multinational groups if the Federal Government has clearly expressed its opposition to such a regime in the context of foreign policy concerns.

In *Container* itself, of course, the Court sustained the application of California's worldwide combined reporting requirement as applied to a U.S.-based multinational group precisely because, at that time, there was no clear statement by the Executive Branch regarding the impact of California's method of taxation on federal foreign policy. As the Court explained in *Container*, the mixed signals sent by the Executive Branch prevented the Court from ascertaining the position of the Executive Branch on California's taxing method:

> The Solicitor General did submit a memorandum opposing worldwide formula apportionment by a State in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349, a case that was argued last Term, and carried over to this Term. Although there is no need for us to speculate as to the reasons for the Solicitor General's decision not to submit a similar memorandum or brief in this case . . . there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case.

Container, 463 U.S. at 195 n.33. The Court thus indicated its reluctance to find that California's method of

taxation impermissibly interfered with federal foreign policy in the absence of an unambiguous statement of the Federal Government's position.

More recently, the Court distinguished the worldwide combined reporting method of taxation which it upheld in *Container* from the ad valorem tax it struck down in *Japan Line* on the ground that " 'in [*Container Corp.*], unlike *Japan Line*, the Executive Branch ha[d] decided not to file an *amicus curiae* brief in opposition to the state tax.' " *Itel Containers Int'l Corp. v. Huddleston*, 113 S. Ct. 1095, 1103 (1993) (quoting *Container*, 463 U.S. at 195). Accordingly, the Court concluded that "the Government's nonintervention suggested that the tax presented no serious threat to United States foreign policy." *Itel*, 113 S. Ct. at 1104.

a. ***The Federal Government Has Issued a Clear Federal Directive Opposing Worldwide Combined Reporting in This Case***

The missing evidence of the Executive Branch's opposition to worldwide combined reporting, which was crucial to the Court's decision in *Container*, has been supplied in this case. In response to a specific request from Colgate that the Federal Government reaffirm its opposition to worldwide combined reporting and make that opposition explicit beyond doubt in the context of U.S.-based multinational groups, the Federal Government issued the following statement:

> As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations.

Letter from Secretary of the Treasury Nicholas Brady to Reuben Mark, Chairman, President, and Chief Executive Officer of Colgate (September 13, 1991) (J.A. 35).[11]

[11] This Court has frequently recognized Executive Branch letters as evidence of the policy of the Federal Government. *See, e.g., Zschernig v. Miller*, 389 U.S. 429 (1968).

Secretary Brady's letter is not the first Federal Government statement referring to this very case in condemning worldwide combined reporting. The correspondence attached to the letter from Secretary Brady reveals that, unbeknownst to the court below or to Colgate, the federal policy against worldwide combined reporting had been reiterated in connection with this very case, while the case was pending before the Court of Appeal. On May 9, 1989, Governor Deukmejian wrote to Secretary Brady objecting to the involvement of the Federal Government in both *Barclays* and *Colgate* and requesting that the Federal Government cease "further involvement in these state tax matters." Letter from George Deukmejian, Governor of California, to Secretary of the Treasury Nicholas Brady (May 9, 1989) (J.A. 47). Governor Deukmejian's letter reflected the view of the State of California at that time that the prior statements of the Federal Government demonstrated its opposition to worldwide combined reporting as applied to both U.S.-based and foreign-based multinational groups. Moreover, in his reply to Governor Deukmejian, Secretary Brady specifically refused to cease further involvement in the "cases contesting California's use of worldwide unitary apportionment." Letter from Secretary of the Treasury Nicholas Brady to George Deukmejian, Governor of California (August 3, 1989) (J.A. 43).

The Federal Government subsequently went even further to explicate its position in this very case by explicitly adopting the views expressed in Colgate's petition for review of the first decision of the Court of Appeal (*see supra* p. 13), filed with the California Supreme Court on September 30, 1991. In explaining that it was unnecessary for the Federal Government to produce yet another document reaffirming its opposition to worldwide combination as applied to a U.S.-based multinational group, the Federal Government declared:

> Colgate-Palmolive filed a Petition for Review in the Supreme Court of California on September 30, 1991. This Petition makes very effective use of

> Treasury's opposition to the use of worldwide unitary tax by the states, as expressed in Secretary Brady's letter of September 13 to Mr. Reuben Mark. Therefore, the Supreme Court of California is now well aware of our position, which has been clear and consistent. We see no reason at this point to submit a brief that would merely repeat the arguments made in the Petition.

Letter from Assistant Secretary of the Treasury Kenneth W. Gideon to Jerry J. Jasinowski, President, National Association of Manufacturers (received November 1, 1991) (J.A. 50-51).

From the foregoing statements emanating from the Federal Government and directed to this very case, the conclusion is inescapable that California's worldwide combined reporting requirement as applied to Colgate violates "a clear federal directive" and must be struck down under the "one voice" standard of the Foreign Commerce Clause.

b. *The Directive in This Case Elaborates on Prior Executive Statements Condemning the Application of Worldwide Combined Reporting to All Multinational Groups*

The Executive Branch statements directed to this case do not, by any means, reflect a new policy of the Federal Government. In fact, these statements simply elaborate on earlier Executive Branch statements that clearly condemn the application of worldwide combined reporting to all multinational groups.

The most important of these is President Reagan's statement of November 8, 1985. J.A. 7-8. Following the Court's decision in *Container*, the President mobilized the Executive Branch to act decisively to avoid perpetuation of the uncertainty regarding federal policy that resulted in the Court's decision. Specifically, President Reagan issued a statement instructing the Secretary of the Treasury to pursue through legislation, and the Attorney General to pursue through litigation, the federal policy "that multinationals be taxed by states only on income

derived from the territory of the United States." *Id.* at 7. This statement—which applies to U.S.-based and foreign-based multinationals alike—plainly demonstrates that worldwide combined reporting is inconsistent with federal policy.

Later statements emanating from the Federal Government reinforce the presidential declaration that California's worldwide combined reporting regime contravenes federal foreign policy. On January 30, 1986, Secretary of State Shultz wrote to Governor Deukmejian to inform him of the proposed federal legislation prohibiting worldwide combined reporting and to explain the foreign policy concerns that prompted the Federal Government's action. In that letter, Secretary Shultz pointedly observed that California's "employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states." J.A. 10. Again, the federal directive opposing worldwide combined reporting draws no distinction between U.S.-based and foreign-based multinationals.

Similar sentiments were subsequently expressed by Secretary of the Treasury James Baker in a letter to Senator Bob Packwood, Chairman of the Senate Finance Committee, condemning worldwide combined reporting in its application to U.S.-based multinational groups (J.A. 13-23); by a Department of Justice *amicus* brief in a case involving *Barclays*, expressing the Federal Government's opposition to worldwide combined reporting (*Barclays* J.A. A-1); and by two statements by Deputy Attorneys General that the views in that *amicus* brief remained unchanged at the time of the trial in this case (J.A. 28-30).

In short, the Federal Government's opposition to worldwide combined reporting as applied to U.S.-based multinational groups reflects long-standing federal policy that was explicitly articulated in response to this Court's opinion in *Container*. Although the Court in *Container* was unable to discern the Federal Government's position on the basis of the evidence then available, a decade of

unequivocal federal directives has made the Federal Government's position clear. In light of the Federal Government's unambiguous hostility to worldwide combined reporting, California's method of taxing multinational groups—U.S.-based as well as foreign-based—cannot survive Foreign Commerce Clause scrutiny because it violates "a clear federal directive."

c. ***Neither the Last-Minute Revisions to California's Worldwide Combined Reporting Regime nor the Recent Submission by the Solicitor General in*** Barclays ***Are an Antidote to Colgate's Foreign Commerce Clause Objections in This Case***

As noted above (*see supra* p. 5, n.4), California has enacted legislation prospectively modifying its worldwide unitary reporting regime in response to the widespread opposition that this regime has engendered. In opposing the grant of certiorari in *Barclays*, the Solicitor General cited these legislative changes as the basis for his conclusion that "[a] decision by this Court on the constitutional question posed in this case is . . . unnecessary to achieve adequate consistency in the Nation's regulation of foreign commerce, which California has striven to accomplish through its voluntary action." S.G. Br. at 10. As we demonstrate below, however, neither the recent California legislation nor the views of the Solicitor General undermine Colgate's Foreign Commerce Clause claim in this case.

First, there is nothing in the recent California legislation that has any effect whatsoever on California's efforts to require Colgate—or thousands of other similarly situated taxpayers—to report on a worldwide combined basis for years prior to the effective date of the legislation. Approximately $1.2 billion in refund claims and $1.9 billion in assessments rest upon the outcome of this case alone, with an additional $500 million in refunds and $350 million in assessments resting upon the outcome in *Barclays*. *See* Report, Senate Rev. & Tax. Comm., S.B.

671 (Alquist), 1993-94 Reg. Sess., August 16, 1993. Accordingly, the constitutional harm that worldwide combined reporting has visited upon Colgate and Barclays remains unmitigated despite California's last-minute legislative attempt to dissuade the Court from considering the merits of *Barclays* and *Colgate*.

Second, the Solicitor General's most recent submission to this Court explicitly recognizes the critical fact that underlies Colgate's claim in this case, namely, that states' use of worldwide combined reporting has long been " 'at odds with the position of the United States and has become a source of conflict with foreign states.' " S.G. Br. at 4 (quoting *Barclays* Pet. App. at H-44). Indeed, the Solicitor General recognizes that California's method of taxation, even after the changes in the law in 1986, is fundamentally inconsistent with federal foreign policy and continues to be an irritant in relations with foreign governments. S.G. Br. at 9.

Third, although the Solicitor General contends that there now has been an "accommodation of state, national, and international interests" (S.G. Br. at 10) on the issue of worldwide unitary combination, the Solicitor General's views ignore the *continuing* foreign opposition to California's taxing regime as well as the *continuing* frustration of United States foreign policy caused by California's aggressive enforcement of preexisting tax liabilities based on worldwide unitary combination. Thus, in an official Demarche, issued *after* the California legislature had passed the recent legislation modifying its worldwide combined reporting requirement, the Member States of the European Community and the Commission of the European Communities notified the United States Government that they "do not consider that the unitary tax problem is solved." *See* Petitioner's Supplemental Brief on Petition for a Writ of Certiorari, App. A at 2a.[12] Moreover, noth-

[12] Indeed, the Solicitor General himself acknowledges that any view as to whether the new California legislation is consonant with

ing the Solicitor General has said changes the fact that *existing* United States foreign policy remains unalterably opposed to states' use of worldwide unitary combination. California's ongoing efforts to apply worldwide combined reporting to Colgate and other taxpayers fly in the face of this longstanding policy.

2. *Worldwide Combined Reporting as Applied to a U.S.-Based Multinational Group "Implicates Foreign Policy Issues Which Must Be Left to the Federal Government"*

As noted above, a state tax will violate the "one voice" standard if the tax "*either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Container*, 463 U.S. at 194 (emphasis in original). The evidence described above which demonstrates that worldwide combined reporting as applied to a U.S.-based multinational group "violates a clear federal directive" (*see supra* pp. 33-38) likewise demonstrates that worldwide combined reporting "implicates foreign policy issues which must be left to the Federal Government."

Secretary Brady's letter of September 13, 1991, and the attachments thereto (J.A. 35-47; *see supra* p. 9) make it clear that worldwide combined reporting as applied to U.S.-based multinational groups implicates foreign policy issues. The letter is written on behalf of, among others, the Secretary of State and the U.S. Trade Representative, Executive Branch officers whose primary concern is foreign policy. Moreover, the letter and the attachments were transmitted specifically for use in this litigation and therefore pertain in the Federal Government's eyes to the propriety of worldwide combined reporting as applied to U.S.-based multinational groups.

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federal foreign policy is no more than speculation. His brief recognizes that issues "might hereafter arise in connection with enforcement of the State's new legislation." S.G. Br. at 10.

There can be no dispute that the letter and attachments reflect the Federal Government's view that worldwide combined reporting implicates relations with foreign nations and thereby interferes with the Federal Government's exclusive power to conduct foreign affairs. As Secretary Brady's response to Governor Deukmejian's letter declares:

> [P]roblems persist with our trading partners over states' use of the unitary method. Because of this issue's continuing international implications, it is not exclusively a state tax issue. We believe that states' use of the worldwide unitary tax method may constitute an impermissible interference in the conduct of the nation's foreign affairs . . . .

Letter from Secretary of the Treasury Nicholas Brady to George Deukmejian, Governor of California (August 3, 1989) (J.A. 43).

If there was any doubt about the Federal Government's position that worldwide combined reporting as applied to a U.S.-based multinational group "implicates foreign policy issues which must be left to the Federal Government," the Federal Government's wholehearted endorsement of Colgate's first petition for review of this case in the California Supreme Court surely removed it. *See* letter from Assistant Secretary of the Treasury Kenneth Gideon to Jerry Jasinowski, J.A. 50-51. One of the central claims in the petition for review was that worldwide combined reporting as applied to U.S.-based multinational groups implicates foreign policy concerns that must be left to the Federal Government. *See* Petition for Review of the First Decision of the Court of Appeal at 6-14. In fact, the very premise of Colgate's statement of position in the petition was that the Federal Government's views are firmly rooted in foreign policy concerns. The Federal Government has approved Colgate's statement of position, without reservation. Not only does the Federal Govern-

ment refer to the petition as making "very effective use of Treasury's opposition to the use of worldwide unitary tax by the states" (J.A. 51), it also states that Colgate's petition fully encompasses the Federal Government's position. Indeed, Assistant Secretary Gideon's letter maintained that there was no need for the Federal Government to file a brief in this case because such a brief would merely duplicate Colgate's petition for review. *Id.*

B. "Competitive Balance" for Domestic Corporations Is an Integral Part of Federal Foreign Policy and Therefore Requires Invalidation of Worldwide Combined Reporting as Applied to U.S.-Based Multinational Groups if Worldwide Unitary Combination Is Found Invalid as to Foreign-Based Multinational Groups

If the Court finds in *Barclays* that worldwide combined reporting is invalid as applied to foreign-based multinational groups for reasons that do not, by their own force, apply to U.S.-based multinational groups, foreign policy considerations of "competitive balance" would independently compel the conclusion that the Foreign Commerce Clause protects a U.S.-based multinational group from worldwide combined reporting.

If California were to apply worldwide combined reporting to U.S.-based multinationals but not to foreign-based multinationals, U.S.-based multinationals would be at a considerable competitive disadvantage in the international marketplace. For example, worldwide combined reporting would continue to pose restrictions to U.S.-based companies seeking to invest abroad, restrictions that would no longer face foreign-based companies seeking to invest in the U.S. Moreover, disparate treatment of U.S.-based and foreign-based multinationals would result in similarly situated taxpayers being subject not only to differing tax burdens, but also to differing administrative burdens.

Recognizing the importance of maintaining a level playing field, the Federal Government has repeatedly stated that the maintenance of competitive balance for

domestic corporations is an integral part of United States foreign policy. Accordingly, insofar as California's application of worldwide combined reporting to U.S.-based multinational groups interferes with the competitive equality of United States business, it interferes with the ability of the Federal Government to "speak with one voice" in a matter of foreign policy.

The importance to United States foreign policy of competitive equality for U.S.-based business has been stressed consistently by those responsible for conducting United States foreign policy. As Secretary of State George Shultz declared in an official Department of State policy statement:

> The strength of the United States in world affairs, including the achievement of our political and security aims, rests directly upon the foundation of a healthy economy. Particularly important in this regard is our nation's vitality *and competitiveness in the international marketplace. Foreign economic and commercial policy is an integral and important element of overall foreign policy.*

Policy Statement on Assistance to U.S. Businessmen, Memorandum for All Assistant Secretaries and Bureau Directors from Secretary of State George Shultz (May 12, 1987) quoted in 133 Cong. Rec. E2723 (1987) (emphasis supplied). Similarly, the Department of State has more recently reiterated the Department's commitment to ensuring competitive equality for American business and outlined a "bill of rights" for American business in the context of United States foreign policy. This includes the right to "[b]e assured that the ground rules for the conduct of international trade are fair and nondiscriminatory." Deputy Secretary of State, Lawrence Eagleburger, quoted in Jim Pinkelman, *Department "Gets Down to Business" by Assisting U.S. Firms, Promoting American Exports,* Vol. 2 No. 17, U.S. Dep't of State Dispatch 306 (April 29, 1991).

Elaborating on these considerations of competitive equality, a letter from the Department of the Treasury to

Governor Deukmejian regarding California's water's-edge legislation emphasizes "the Administration's desire for equitable state tax treatment of foreign and domestic corporations." Letter from Assistant Secretary of the Treasury J. Roger Mentz to George Deukmejian, Governor of California (April 8, 1987) (J.A. 24). Dubbing this "The Equity Issue," Treasury urged California to agree that "place of incorporation should be irrelevant" and that "there is no valid policy justification" for California subjecting U.S.-based and foreign-based multinational groups "to different tax regimes." J.A. 25-27.[13]

More recently, Treasury has reaffirmed its view that considerations of competitive balance require equal treatment of U.S.-based and foreign-based multinational groups and that neither should be subjected to worldwide combined reporting. Treasury declared that "[a]s a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations." Letter from Assistant Secretary of the Treasury Kenneth Gideon to Jerry Jasinowski, President, National Association of Manufacturers (November 1, 1991) (J.A. 50). Treasury further observed that it had testified before Congress that treaty-based limitations on worldwide combined reporting were less desirable than state or federal legislative restrictions on such reporting "*precisely because they would benefit foreign-parent multinationals but not domestic-parent multinationals and thus not 'satisfy the principle of ensuring competitive balance among similarly situated businesses.'*" *Id.* (citing testimony of J. Roger Mentz, Treasury Assistant Secretary (Tax Policy), before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, Sept. 29, 1986, p. 3) (emphasis supplied). Treasury concluded that "[o]ur position has not changed." *Id.* *See also* letter from Treasury Secretary Nicholas Brady to Reuben Mark, President, Chairman, and Chief Executive Officer of Colgate (September 13, 1991) (J.A. 35).

[13] Moreover, any taxing scheme that attempts to differentiate between U.S.- and foreign-based groups on the basis of the place of incorporation is fraught with problems in light of the fact that many foreign-based groups contain sub-groups that have the United States as their place of incorporation, and, similarly, many U.S.-based companies have sub-groups incorporated overseas.

In short, competitive balance is an issue that is inextricably interwoven with federal foreign policy concerns and is protected under the "one voice" standard of the Foreign Commerce Clause. If the Foreign Commerce Clause proscribes worldwide combined reporting for foreign-based multinational groups, such reporting is likewise proscribed for U.S.-based multinational groups. The court below therefore erred in dismissing Colgate's Foreign Commerce Clause argument on the theory that federal policy against worldwide combined reporting insofar as it applied to U.S.-based multinational groups rested solely "on 'competitive balance' grounds" (Pet. App. E at 61a).

C. The Foreign Commerce Clause Demands Equal Treatment of U.S.-Based and Foreign-Based Multinational Groups with Respect to Worldwide Combined Reporting

Wholly apart from Colgate's foreign policy-based contention that "competitive balance" considerations preclude California from requiring Colgate to report on a worldwide combined basis if a similar requirement may not be imposed on foreign-based multinationals, basic principles of Commerce Clause analysis independently require that Colgate be accorded the same treatment accorded foreign-based multinationals.

This Court has held that the Commerce Clause forbids the states from preferring one form of "protected" commerce over another. The Court addressed this question in *Boston Stock Exchange*, where it struck down a state tax statute that favored one form of interstate commerce over another. The Court explicitly rejected the view of the New York Court of Appeals that discrimination between different types of transactions in interstate commerce was permissible. *Boston Stock Exchange*, 429 U.S.

at 333. In particular, the Court disapproved discrimination between different forms of protected commerce where such discrimination would cause a "diminution of free competition," a result the Court viewed as "wholly inconsistent with the free trade purpose of the Commerce Clause." *Id.* at 336.

The same analysis requires that U.S.-based multinational groups engaged in foreign commerce be accorded the same treatment accorded foreign-based multinational groups engaged in foreign commerce. If California were permitted to apply worldwide combined reporting to U.S.-based multinational groups like Colgate and its affiliates, which are engaged in foreign commerce,[14] but not to foreign-based multinational groups like Barclays and its affiliates, which are likewise engaged in foreign commerce, the resulting competitive advantage to foreign-based multinational groups would seriously undermine the level playing field for different forms of protected foreign commerce and with it the free trade concerns protected by the Commerce Clause.

The necessity for equal treatment for all forms of protected commerce was reemphasized last term when the Court struck down a state taxing scheme that favored interstate over foreign commerce. *See Kraft*, 112 S.Ct. 2365. In addition, in a decision that this Court affirmed by an equally divided Court, the California Court of Appeals explained:

> Discrimination between (1) interstate transactions and foreign transactions cannot be distinguished from (2) discrimination between two types of interstate transactions. Both interstate and foreign transactions

[14] This Court has recognized that U.S.-based multinational groups with foreign operations engage in foreign commerce. *See Container*, 463 U.S. at 188-89 ("[T]he tax here falls . . . on a corporation domiciled and headquartered in the United States. We specifically left open in *Japan Line* the application of that case to 'domestically owned instrumentalities *engaged in foreign commerce*' . . . this case falls clearly within that reservation" (emphasis supplied)).

> are brought within the control of Congress by the same clause of the United States Constitution.

Zee Toys, Inc. v. County of Los Angeles, 85 Cal. App. 3d 763, 775, 149 Cal. Rptr. 750, 758 (2d Dist. 1978), *aff'd by an equally divided Court sub nom. Sears, Roebuck & Co. v. County of Los Angeles*, 449 U.S. 1119 (1981). Hence the Commerce Clause prohibits a taxing scheme that favors foreign commerce conducted through foreign-based multinational groups over foreign commerce conducted through U.S.-based multinational groups. It therefore requires that U.S.-based multinational groups be spared the burden of worldwide combined reporting if such burden may not be imposed on foreign-based multinational groups.

Although the Court found it unnecessary to reach this issue in *Container*, several members of the Court made it clear that invalidating worldwide combined reporting as applied only to foreign-based multinationals would be unacceptable because "[i]t would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation." *Container*, 463 U.S. at 203 (Powell, J., dissenting). In short, if California's worldwide combined reporting requirement as applied to foreign-based multinational groups violates the Commerce Clause, then application of the same requirement to U.S.-based multinational groups such as Colgate cannot withstand constitutional scrutiny.

CONCLUSION

The judgment of the Court of Appeal should be reversed.

Respectfully submitted,

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
FRANKLIN C. LATCHAM
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

Dated: December 15, 1993

(23)

No. 92-1839

FILED
JAN 19 1994
OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1993

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

BRIEF OF RESPONDENT

DANIEL E. LUNGREN
Attorney General of the State of California

LAWRENCE K. KEETHE
Supervising Deputy Attorney General

JOHN D. SCHELL
Deputy Attorney General
Counsel of Record

Attorneys for Respondent

1515 K Street
P.O. Box 944255
Sacramento, California 94244-2550
(916) 324-5154

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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QUESTIONS PRESENTED

1. Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant Commerce Clause, may be found by implication from congressional actions.

2. If a dormant Commerce Clause analysis were appropriate, whether worldwide combined reporting as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the foreign Commerce Clause.

3. Whether a purely prospective application should be made of any decision on the merits which concludes, contrary to this Court's existing precedent, that California's worldwide combined reporting tax method is unconstitutional as applied to a domestic-based business.

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SUPPLEMENTAL STATEMENT OF THE CASE

INTRODUCTION

Respondent Franchise Tax Board ("FTB") makes the following points in addition to those stated in Colgate-Palmolive Company's ("Colgate's") Brief.[1]

The basic question in this case is whether California's requirement of worldwide combined reporting (hereafter WWCR) may be constitutionally applied to a U.S. based multinational group. This very question was answered affirmatively by this Court in *Container Corp. of Am.* v. *Franchise Tax Bd.*, 463 U.S. 159 (1983) (hereafter *"Container"*). In the courts below Colgate attempted to distinguish the *Container* rule on the basis that post-1983 Executive Branch statements and correspondence furnished the evidence of a clear federal directive that was missing in *Container*. This argument was rejected by the California Court of Appeal in its first decision (Pet. App. E), which found that these statements did not constitute a clear federal directive in the context of this domestic parent multinational group and that under *Container* the California method was constitutionally valid. Pet. App. E at 49a-66a. In that decision the Court of Appeal also found that Colgate's additional "competitive balance"

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[1] FTB adopts Colgate's reference of J.A. for the Joint Appendix and Pet. App. for the Appendix to Colgate's petition for certiorari to this Court. Colgate's Brief on the merits is designated as Br. CT refers to the original court file. Trial Exhibits are identified by number (for Colgate's) or letter (for FTB's), and may also include a joint exhibit reference for stipulated exhibits. Thus Ex. 37, J.E. 36 refers to Colgate's trial exhibit 37, joint exhibit 36. Frequently several joint exhibits were admitted as one trial exhibit.

issue does not arise under the foreign Commerce Clause "once voice" test (Pet. App. E at 60a) and that equal treatment of foreign-parent and domestic-parent groups was not required. Pet. App. E at 61a, fn. 10. Respondent will address these issues as well as the argument raised by Amici that *Container* was wrongly decided and should be overturned (Brief of Amici Curiae Chamber of Commerce of the United States of America, National Association of Manufacturers, and United States Council for International Business in Support of Petitioner), and the question of retrospective application of the decision in this case.

A. Colgate-Palmolive Company's Unitary Business.

In rejecting Colgate's argument that its foreign subsidiaries were autonomous and independent, the trial court found that Colgate was engaged in a unitary business, citing the following specific transfers of value: Colgate "furnished its subsidiaries with raw material, information and equipment; aided in engineering problems; developed specific accounting procedures and policies; guaranteed loans; and . . . transferred its personnel around to effect its worldwide objectives. It transferred general managers from subsidiary to subsidiary, shared in marketing experience and expertise and, to a small extent, offered its rather meager research and development knowledge to the subsidiaries." Pet. App. F, 78a-79a.

B. The separate accounting method.

Tax treaties and the Internal Revenue Code require arm's length separate accounting (hereafter AL/SA) only for national taxes. Exhibit 7, *Container*, at 196. There is no requirement that subnational taxes be imposed on the AL/SA basis. The AL/SA method fails to reflect the flow of value resulting from operational interdependencies, economic interdependencies, and functional integration between and among the parts of the worldwide unitary business. Pet. App. F at 85a-87a; *Container* at 164-5.

C. California Taxing Scheme.

WWCR is a proper and fair method of taxation which reflects a reasonable sense of how income is generated, and which avoids the basic theoretical weakness of AL/SA. *Container* at 169-70, 181, 184.

D. Opposition to California's Taxing System.

Colgate's assertion at Br. 7 that "on the domestic front, the Federal Government has pursued a policy opposing states' use of worldwide combined reporting" is without basis. In *Container* this Court noted that the "Federal Government to the degree it has spoken, seems to prefer [for its own tax law] the taxing method adopted by the international community to the taxing method adopted by California" *Id.*, 463 U.S. at 167. However, the *Container* Court did not find a policy opposing the states' use of the WWCR, and Colgate has not established the existence of such a policy.

One purpose of forming the Worldwide Unitary Taxation Working Group in 1983 after the *Container* decision was announced was to "advise and assist in the *development of a policy* dealing with the complex issues involved in the states' use of the worldwide unitary method of taxation." Ex. 37, J.E. 36. (Emphasis added.) The policy developed by the Working Group was to encourage voluntary state legislation adopting the "waters edge" principle. The President later supported federal legislation and gave instructions to the Attorney General to ensure that the United States' interests were represented in appropriate cases. J.A. 7-8. The United States has not filed an Amicus Brief or otherwise appeared in this case. Congress has not passed any legislation which restricts the power of the states to impose WWCR.

E. The Tax Assessment.

Colgate in its claims for refund contended that its worldwide operations did not constitute a unitary business. It also raised the constitutional issues of violation of the Due Process and Equal Protection Clauses by reason of taxation of extraterritorial values and violation of the Commerce Clause by reason of double taxation and impairment of the ability of the United States to speak with "one voice" in carrying out foreign policy. Colgate also contended that application of the combined reporting formula unlawfully distorted its income. Ex. 12, J.E. 7a-7d.

F. The Proceedings Below

1. Superior Court of California

Colgate's complaint raised the same issues as the claims for refund. The complaint also alleged that "there was no mutual dependence or significant contribution between the foreign subsidiaries and Colgate, and that they were in no way unitary with plaintiff." CT 4, para. 8. In discovery Colgate alleged that substantially all of its intercorporate operational documents had been destroyed and were no longer available. CT 1350-1356. The two week court trial was concerned primarily with the determination of whether Colgate's worldwide operations were unitary, and to a lesser degree the distortion issue. The foreign Commerce Clause constitutional issue was submitted on the basis of stipulated documents. In the course of the trial FTB discovered two boxes containing supposedly destroyed operational documents. CT 1943:9-1945:8.

The trial court held that Colgate's operations were unitary, finding that the evidence in favor of unitary treatment was substantially stronger than that of the taxpayer in *Container*. Pet. App. F, 80a. The trial court also relied on *Container* in finding that there was no showing of distortion. *Id.*, 81a-87a. On the foreign Commerce Clause issue, however, the trial court found the unitary method unconstitutional, holding that "it is the policy of the United States, speaking through the executive branch, that the water's edge system be followed and the unitary method discarded." *Id.*, at 91a.

2. Court of Appeal of California (First Decision)

In ruling on FTB's appeal of the trial court decision[2] the Court of Appeal rejected FTB's argument that under *Wardair Canada Inc.* v. *Florida Dep't of Rev.*, 477 U.S. 1 (1986) (hereafter "*Wardair*"), dormant Commerce Clause analysis was precluded. However, in applying dormant Commerce Clause analysis the court found that none of the statements or letters relied upon by Colgate linked domestic-parent groups to issues of foreign commerce or foreign affairs, and that they were ambiguous in the domestic-parent context.[3] The Court of Appeal stated "Because we conclude that the evidence relied upon by Colgate does not show any foreign policy implications or clear federal directives which alter the *Container* 'one voice' analysis, that analysis remains valid in the context of this case." Pet. App. E, 63a.

The Court of Appeal also noted the difference between the application of the tax to foreign-parent groups and domestic parent groups, *id.*, at 64a, and the fundamental issue of federalism presented by this case. *Id.*, at 65a. After noting that the federal executive did not act to represent federal interests in this case, the Court again concluded: "In this posture, we cannot say that California's application of the worldwide unitary tax

[2] Colgate did not appeal the trial court's decision.

[3] In its analysis of Secretary Baker's letter to Senator Packwood (Joint Appendix 13-23) the Court of Appeal noted that the policy of "competitive balance" noted in that letter is not an issue under the dormant Commerce Clause "one voice" test. Pet. App. E, at 60a.

method to domestic-parent groups with foreign subsidiaries is unconstitutional under the foreign commerce clause because it either impermissibly interferes with the conduct of foreign policy or violates a clear federal directive. In this light, *Container's* conclusion remains valid that such 'taxation is in reality of local rather than international concern.' " *Id.*, at 65a; citation omitted.

The Court of Appeal also rejected Colgate's distortion argument, in part because of the failure of Colgate's separate accounting methods to account for the flow of value between the parts of the unitary business. *Id.*, at 68a.

Finally, the Court of Appeal declined to consider Colgate's argument that foreign-parent and domestic-parent groups must be treated identically for tax purposes on the basis that the issue was not ripe for determination. *Id.*, at 66a, fn. 12. The Court also noted that the issue was not litigated meaningfully below, was not part of the trial court's decision, and was not adequately briefed. *Id.*

3. Supreme Court of California (First Petition for Review)

In its petition to the California Supreme Court, Colgate contended that a letter from Secretary Brady dated September 13, 1991, J.A. 35-47 supplied the "clear directive" that the Court of Appeal had found lacking. Colgate also urged the issues of competitive balance and equal treatment between domestic-parent and foreign-parent groups, and sought review of the distortion issue. The California Supreme Court granted the petition (Pet. App. A at 28a), but before FTB had filed its brief on the merits

it issued its *Barclays*[4] decision. The California Supreme Court ordered the case transferred back to the Court of Appeal with directions to modify its opinion in light of *Barclays*. Pet. App. C at 27a.

4. Court of Appeal of California (Second Decision)

In its second decision the Court of Appeal modified its foreign Commerce Clause analysis in accord with *Barclays* noting: "As *Barclays* explains '[i]n some cases where Congress affirmatively declines to adopt certain measures, the resulting governmental "silence" is not the sort that triggers use of a dormant foreign commerce clause analysis.' " Pet. App. B at 16a; citation omitted. The Court of Appeal found that the factors cited in *Barclays* were equally applicable to this case and held that Congress had acted to permit the tax here at issue; consequently there was no foreign Commerce Clause violation. Pet. App. B at 18a.

5. Supreme Court of California (Second Petition for Review)

On February 18, 1993, the California Supreme Court denied Colgate's petition for review of the modified opinion of the Court of Appeal. Pet. App. A at 1a.

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[4] *Barclays* refers to the companion *Barclays Bank PLC* v. *Franchise Tax Board*, No. 92-1834.

SUMMARY OF ARGUMENT

1. The California Court of Appeal has correctly applied the California Supreme Court decision in *Barclays* to this case and determined that there had been affirmative congressional action which precluded dormant Commerce Clause analysis. The arguments on this point are set forth in FTB's brief in *Barclays*, No. 92-1384, and will not be repeated here.

2. California's tax system does not violate the *Japan Line*[5] "one voice" standard which was met by this very same state income tax dealt with in *Container*. Colgate has failed to show either violation of a clear federal directive in the foreign commerce context or implication of foreign policy issues within the *Container* decision.

First, Colgate has produced no evidence of a clear federal directive in the context of this case. The California Court of Appeal carefully analyzed the presidential statement and each of the executive letters offered by Colgate and found that they did not constitute such a clear directive. Pet. App. E at 49a-62a. After oral argument in the Court of Appeal, Colgate urged the Executive Branch to file an amicus brief making explicit a federal policy against worldwide unitary taxation as applied to U.S. based multinationals.[6] J.A. 31-34. Treasury's reply was a letter which asserted "tax policy" as a basis for equal

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[5] *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), cited hereafter as "*Japan Line*".

[6] Colgate's letter reveals that Colgate perceived the court's comments at oral argument as indicating that Colgate would lose without such an amicus brief. J.A. 33.

opposition to unitary taxation of domestic-parent and foreign-parent multinationals. It is this letter that Colgate argues constitutes a "'clear federal directive' in this very case . . . " Br. 17.[7]

FTB maintains that neither this letter, nor any of the previous executive materials relied on by Colgate, is either "clear" in the foreign policy one voice context, or a directive. Further, this 1991 letter issued eight years after the *Container* decision and twenty years after the 1970-1973 years at issue is totally inapposite to this case. Colgate admits that there was no clear federal directive at the time of the *Container* decision. Colgate's Second Petition to California Supreme Court dated December 30, 1992, at 20.

Finally, the power to regulate foreign commerce is a Congressional power. Const. Art. I, § 8, cl. 3. To be cognizable under the foreign Commerce Clause, the clear federal directive must be congressional. See *Container*, 463 U.S. at 194:

> " . . . In conducting this inquiry, however, we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some

[7] FTB is at a distinct disadvantage as to these items of post-trial "evidence" produced by Colgate. FTB has no basis for objecting to the status of these letters as official actions of the Executive Branch of the United States Government subject to compulsory judicial notice under California Evidence Code Sections 452-453, but also has had no opportunity to conduct any discovery regarding the circumstances under which the letters were issued.

> explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States.' (Citations omitted.)"

3. Colgate's arguments that if WWCR is found to be invalid in the foreign-parent context, it must also be invalid as applied in the domestic-parent context under considerations of "competitive balance" and "equal treatment" also must be rejected. First, these issues were not raised in Colgate's claims for refund, Ex. 12, Joint. Ex. 7a-7d, and thus are not properly before this Court to decide. *Jimmy Swaggart Ministries* v. *Board of Equalization of the State of California*, 493 U.S. 378, 397-398 (1990). Further, these issues do not come under the one-voice dormant Commerce Clause analysis of *Container* (see Pet. App. E at 60a-60b), and are not within the scope of the questions stated in Colgate's petition.

Finally, Colgate has furnished no factual basis for considering these issues here. *Barclays* involves income year 1977 (franchise tax year 1978). Colgate has presented no evidence regarding the number of claims for refund pending in the foreign-parent context for the Colgate tax years 1970-1973 which are before this court. For those years, all other taxpayers will continue to be treated the same, regardless of the outcome of *Barclays*. Colgate has not shown that *Barclays* would have any significant effect on the competitive balance or equality of treatment for the Colgate years. As to all years, including years subsequent to 1977, there is insufficient basis for this Court to determine which way the competitive balance would be slanted, or to what extent, if WWCR were held to be

unconstitutional as to foreign-parent groups and valid as to domestic-parent groups for the years at issue.

Amici Chamber of Commerce, et al., erroneously rely on double taxation as a reason for overturning *Container*. If there is double taxation in the context of this case it results from the failure of AL/SA to properly allocate the income arising from the flow of value among and between the members of the unitary group. Extraterritorial value is being taxed under AL/SA, not by California.

Finally, because Colgate has presented no basis for relief for the years at issue, this Court should reserve the question of retrospective relief as to Colgate and apply any adverse decision on the constitutionality of WWCR as applied to domestic-parent groups prospectively only.

ARGUMENT

I. THE SUPREME COURT OF CALIFORNIA CORRECTLY DETERMINED THAT CONGRESSIONAL CONSENT TO THE APPLICATION OF WWCR TO MULTINATIONAL CORPORATE GROUPS PRECLUDES DORMANT COMMERCE CLAUSE ANALYSIS.

FTB adopts the argument on this issue set forth in its brief in *Barclays*, No. 92-1384.

II. AS THIS COURT HELD IN *CONTAINER*, WWCR AS APPLIED TO A U.S. BASED MULTINATIONAL GROUP DOES NOT PREVENT THE FEDERAL GOVERNMENT FROM "SPEAKING WITH ONE VOICE."

A. Introduction

In *Japan Line* this Court began developing the applicable test for determining the constitutionality of a state tax under the Commerce Clause when instrumentalities of foreign commerce are involved:

> "In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." 441 U.S. at 451.

Container refined the "one voice" test: "a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Id.*, at 194. Emphasis in original. *Container* also noted that "if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some explicit directive from Congress, . . . that the treatment of foreign income at the

federal level mandates identical treatment by the states.' " (Citations omitted.) *Id.*

Thus there were two prongs in the *Container* one-voice analysis: (1) whether Congress had spoken in an explicit directive mandating state taxes to follow federal practice; or (2) whether a dormant Commerce Clause analysis must conclude that the state tax prevents the Federal Government from speaking with one voice. *Container* did not consider the third alternative: whether Congress had acted to *permit* state use of WWCR as shown above.

B. There is no clear Federal directive barring California's use of WWCR.

1. A clear Federal directive, to be cognizable under the Foreign Commerce Clause, must come from Congress.

If there is either congressional action permitting state use of WWCR or an explicit directive from Congress which bars state use of WWCR, then no dormant Commerce Clause analysis is necessary. Colgate errs in placing consideration of purported "clear Federal directives" within its *dormant* Commerce Clause analysis.

Any clear Federal directive barring WWCR must emanate from Congress. This interpretation is consistent with the grant to Congress under Article I, section 8, clause 3 of the Constitution of the power to regulate commerce with foreign nations. The Congressional power in this regard is exclusive and absolute. *Buttfield* v. *Stranahan*, 192 U.S. 470, 492-493 (1904). Accordingly, only Congress has the power to take pre-emptive action. See

Container at 194: "The second of the considerations, of course, is essentially a species of pre-emption analysis" and at 197: "Thus, whether we apply the 'explicit directive' standard articulated in Mobil, or some more relaxed [dormant Commerce Clause] standard which takes into consideration our residual concern about the foreign policy implications of California's tax, we cannot conclude that the California tax issue here is *pre-empted by federal law* or fatally inconsistent with federal policy." (Emphasis added.) See also *Wardair* at 477 U.S. 6:

> "But we have consistently emphasized that the first and fundamental inquiry in any pre-emption analysis is whether Congress intended to displace state law, and where a congressional statute does not expressly declare that state law is to be pre-empted, and where there is no actual conflict between what federal law and state law prescribe, we have required that there be evidence of a congressional intent to pre-empt the specific field covered by the state law." (citations omitted)

2. The presidential statement and Executive Department letters relied on by Colgate are neither "directives" nor do they state clear opposition to WWCR as a foreign policy matter in the context of this case.

a. Executive statements, letters, or even amicus briefs are not federal directives.

First, it must be noted that the "evidence" of purported "clear Federal directives" relied upon by Colgate arose subsequent to the 1983 decision in *Container*. In fact, Colgate contends that this "policy" " . . . was explicitly

articulated in response to this Court's opinion in *Container*." Br. 37. Colgate has offered no cognizable evidence that any such "policy" existed before the *Container* decision, and certainly no evidence that it existed in the tax years 1970-73 which are before this Court. Colgate has made no attempt to bridge this chasm between the tax years at issue and the executive statements upon which it relies. California could not have been violating any 1980's "clear Federal directives" in the early 1970's.

Colgate apparently interprets *Container* to hold that an amicus brief by the Solicitor General filed in that case would have constituted a clear federal directive that would have required invalidation of the California law. Br. 34-36. Colgate is in error. The *Container* court expressly noted that lack of such a submission was not dispositive. *Id.* at 195-196. Nor would submission of such a brief have been conclusive. An amicus brief has no weight beyond the power to persuade. See Justice Blackmun's dissent in *Itel Containers Int'l Corp.* v. *Huddleston*, 113 S.Ct. 1095, 1110 (1993). See also *Wardair*, 477 U.S. at 9-11, wherein this Court discussed the argument advanced by the United States as Amicus that there was a federal policy to exempt all air line fuel from taxation. In rejecting the U.S. argument that the Resolution of the International Civil Aviation Organization represented such a policy of the United States, this Court noted that no action had been taken to give the Resolution the force of law. *Id.* at 11. Clearly, a statement by a member of the Executive Branch that a policy exists, even in the form of an amicus brief, neither establishes that the policy exists as a matter of United States law, nor has the pre-emptive force of a directive to invalidate a state tax law.

In certain circumstances, such as the case of a presidential proclamation pursuant to a valid delegation of power by Congress, see *United States* v. *Curtiss-Wright Export Corp.*, 299 U.S. 304 (1936), the Executive Branch could issue a directive that would have the force of law which this Court could regard as having pre-emptive effect as to some state actions. However, none of the executive statements relied on by Colgate herein draws upon such an authority to have the force of law.

Further, the specific statement relied upon by Colgate as constituting the missing federal directive needed by Colgate in this case falls far short of carrying even the weight of an amicus brief. The statement was a reply to a letter from Colgate's Reuben Mark to Secretary Brady, J.A. 31-34, which requested that the Executive Branch "announce explicitly that the federal policy against worldwide unitary taxation applies to U.S. based multinationals. . . . We believe that the most effective means of communicating this federal policy would be the filing of an amicus brief in the Colgate case."

Rather than filing an amicus brief or otherwise intervening in the *Colgate* case, or even issuing an "explicit announcement", Secretary Brady replied by a letter to "Dear Reuben" which stated that "As a *tax policy matter*, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations." J.A. 35. (Emphasis added.) The letter and its attachments, J.A. 37-47, do not even state any foreign policy basis for the asserted opposition with respect to domestic-based corporate groups.

Secretary Brady's letter also mentions that Mr. Mark wrote similar letters to the Secretary of State, the U.S. Trade Representative, and the Acting Attorney General and that they would be making a coordinated reply. J.A. 35. Colgate has furnished no indication that any of these other officials responded.

Clearly, none of the executive departments filed an amicus brief or otherwise appeared in the *Colgate* case at Mr. Mark's request. Apparently, there was not even complete agreement among the executive departments as to the significance of this issue. In any event, Secretary Brady's letter falls far short of constituting a federal directive. It does not even attempt to direct California to conform to federal tax practices. It certainly is a woefully insufficient basis for invalidating a state law under the foreign Commerce Clause of the United States Constitution.

b. Colgate's other executive statements regarding WWCR fail to constitute federal directives.

The prior executive statements cited by Colgate at Br. 36-38 suffer the same infirmities as the Brady letter. Inasmuch as they arise from the Executive Branch, rather than Congress, they cannot constitute "clear federal directives" in the foreign Commerce Clause context. *Container*, at 194. Additionally, these statements do not have the force of law. *Wardair*, at 11. They at most represent aspirations of the Executive Branch or Treasury, not the binding policy of United States law. See *Id.*, at 10. Finally, these statements do not even clearly express, within the foreign

Commerce Clause context, opposition against WWCR as applied to domestic-based multinationals.

c. Under the dormant Commerce Clause "one voice" test, WWCR as applied to a domestic-based multinational group such as Colgate does not implicate foreign policy issues which must be left to the federal government.

1. Executive statements presented by Colgate do not establish implication of foreign policy issues which must be left to the Federal Government.

a. Documents relating to the Unitary Working group

The policy formulated as a result of the efforts of the Worldwide Unitary Working Group demonstrates a lack of "one-voice" foreign policy implications. This Court in *Container* recognized a distinction between those state taxes that merely have foreign *resonances* (and thus are valid absent an explicit directive from Congress) and those taxes which *implicate* foreign affairs (and thus may be invalid). *Id.*, at 194. This Court concluded based on the information before it that California's tax as applied to a domestic-based multinational group did not come within this second classification. Colgate wishes to change that result on the basis of the executive statements issued subsequent to the *Container* decision. FTB submits that these statements are not sufficient to meet Colgate's goals.

In fact, Colgate's evidence reveals that the purpose of the Worldwide Unitary Taxation Working Group formed

in 1983 was to "advise and assist in *development* of a policy dealing with the complex issues involved in the states' use of the worldwide unitary method of taxation." (Emphasis added) Ex. 37, J.E. 36. The Working Group developed three Principles to be used by the *states* in developing specific legislative measures:

> "Principle One: Water's edge unitary combination for both U.S. and foreign-based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." J.A. 19-20.

The *policy* adopted by the Executive Branch was to encourage the states to adopt principles one and three without federal legislative intervention. J.A. 20. On November 8, 1985, the Executive modified that policy by stating its support for the concept of federal legislation that would restrict state taxation of multinationals to water's edge combination and address the taxation of foreign source dividends. The statement also proposed amendment to double taxation agreements, enactment of domestic "spreadsheet" legislation, and instructed the Attorney General to represent the interests of the United States in appropriate cases. J.A. 7-8. The Executive Branch subsequently withdrew its support for federal water's edge legislation based on the progress of the states toward achieving these goals. J.A. 43.

FTB submits that the above only shows an executive *aspiration* to restrict state use of WWCR to the water's

edge approach. It also shows that even the Executive did not perceive the issue to be of such compelling significance that it required an immediate and uniform federal solution, but looked upon the issue as one that should be resolved voluntarily by the states through the legislative process. Finally, the Executive recognized that if the states failed to act, then the solution was to request Congressional action through legislation. J.A. 13-23. This was an implicit recognition by the Executive Branch that the power in this area did not belong to the Executive, but to Congress.

Congress, for its part, apparently did not perceive this issue as being one of interference with foreign commerce or disagree with this Court's *Container* holding. Certainly the issue and the *Container* decision were brought to the attention of Congress (see e.g., J.A. 19) but it took no action to restrict California's authority to tax nor did it otherwise express disagreement with this Court's interpretation. The failure of Congress to take action to affect the *Container* result indicates acquiescence by Congress in that decision. See *Johnson* v. *Transportation Agency*, 480 U.S. 616, at 629 n. 7 (1980), discussing the significance of Congressional inaction on a high profile issue:

> "As one scholar put it, 'When a court says to a legislature, 'You (or your predecessor) meant X,' it almost invites the legislature to answer: 'We did not'. (Citation omitted.) Any belief in the notion of dialogue between the judiciary and the legislature must acknowledge that on occasion an invitation declined is as significant as one accepted."

The actions of Congress and the Executive indicate that both of these branches agreed with this Court that California's method of WWCR did not have foreign policy implications which must be left to the federal government, but rather that, at most, WWCR raised resonances which should be treated by independent action by the states.

b. Colgate's other executive statements fail to demonstrate foreign policy implications in the context of this domestic-parent case.

Colgate's assertion that Secretary Brady's letter of September 13, 1991, and attachments, J.A. 35-47, was written on behalf of the Secretary of State and the U.S. Trade Representative is belied by the language of the letter itself. The letter states that those officials "are responding by referencing this letter." J.A. 35. Colgate has furnished no evidence that the Secretary of State, the U.S. Trade Representative or the Secretary of State did respond.

Secretary Brady's letter also does not state *foreign* policy implications of the California tax, but rather states opposition "as a *tax* policy matter . . . " citing as a basis "competitive balance." As noted above, competitive balance was an area that the Executive determined was appropriate for the states to resolve voluntarily through the legislative process, J.A. 20, an approach inconsistent with any determination that WWCR implicated foreign policy. None of the attachments to the letter, J.A. 37-49,

addresses foreign policy concerns resulting from the application of California's tax method to a domestic-parent group.

Colgate's reliance on Secretary Brady's letter of August 3, 1989, J.A. 43-44, is misplaced in this domestic-parent case. That letter references the position taken by the United States in "*amicus curiae* briefs filed in cases such as *Barclays Bank International, Ltd.* v. *Franchise Tax Board*, 3 Civ. C003388 and 3 Civ. C003389, Cal.App 3rd App. Dis." The referenced *amicus* brief expressly addresses this issue in the foreign-parent context.

Secretary Schultz' letter of January 30, 1986, J.A. 9-12, focuses on the foreign reaction to the tax. The foreign concerns addressed in the letter (foreign entry into the United States market, administrative burdens of compliance, British retaliatory legislation) arise in the foreign-parent context. See *Container*, 202-203, dissenting opinion by Justice Powell.

Secretary Baker's letter of March 5, 1986, to Senator Packwood (J.A. 13-23) also cites foreign-parent-based concerns for the administration's opposition to world-wide unitary taxation. Again, the factors cited are risk of double taxation, administrative burdens and impedance of foreign entry into the United States market. J.A. 17-19. As noted above, the primary significance of these factors is in the foreign-parent context.

Finally, Colgate's assertion at Br. 41 that Assistant Secretary Gideon's letter to Mr. Janowski, J.A. 50-51, constituted the Federal Government's "whole-hearted endorsement of Colgate's first petition for review of this case in the California Supreme Court" is an overstatement. Mr. Gideon's discussion of the petition refers only

to the *Treasury's* opposition as expressed in Mr. Brady's letter of September 13. J.A. 35-36. Both that letter and Mr. Gideon's letter refer to *tax policy*, and not foreign policy, as the basis of Treasury's opposition to WWCR. Mr. Gideon's statement that Colgate's brief makes effective use of Treasury's opposition as stated in Mr. Brady's letter does not mean that Treasury endorsed all of the arguments made by Colgate.

This letter, and all of the other letters relied upon by Colgate in this matter, demonstrate that Colgate has, since the *Container* decision, desperately urged the different departments of the Executive Branch to intervene in this matter with a clear statement, in the form of an amicus brief, that California's tax system as applied to domestic-parent groups interferes with the foreign policy of the United States. The Executive Branch has failed to file such a brief, or otherwise furnish such a clear statement. All that Colgate has been able to obtain are a few letters from Treasury asserting "tax policy" and "competitive balance" as the basis for its opposition to WWCR as applied to Colgate. The federal Executive as a whole has apparently had little interest in this case; certainly less interest than it has had in *Barclays*.

2. Colgate's "competitive balance" issue is not properly before the Court and is not part of the "one voice" dormant Commerce Clause analysis of Japan line.

Colgate's claims for refund do not raise "competitive balance" as part of the "one voice" issue. Accordingly,

this issue is not properly before this Court. *Jimmy Swaggart Ministries* v. *Board of Equalization of the State of California*, 493 U.S. 378, 397-399 (1980). Additionally, Colgate has failed to establish a factual record from which this Court could determine the relative "competitive balance" if domestic based groups remained subject to the tax, and foreign-based groups were taxed under the AL/SA method, either for the years at issue or subsequently. Finally, "competitive balance" is not an area which requires federal uniformity within the purview of the foreign commerce clause.

a. The issue of "competitive balance" was not raised as a foreign Commerce Clause issue in Colgate's claims for refund and is not an issue properly before this court.

Colgate's claim for refund asserts foreign Commerce Clause issues as follows:

> "Second, because the income misapportioned to the United States members of the group is fully taxed in the foreign country where it is earned, the income is subject to double taxation in violation of the commerce clause, Article I, section 8, clause 3 of the United States Constitution. *Japan Line, Ltd.* v. *County of Los Angeles*, 441 US 434 (1979); *Western Live Stock* v. *Bureau of Revenue* 303 US 250 (1938). Finally, the inconsistency of worldwide apportionment as compared with the separate accounting, arms length method used by the United States and by foreign governments impairs the ability of the United States to speak with one voice in carrying out its foreign

policy, thereby, violating the commerce clause and the supremacy clause, Article VI, clause 2 of the United States Constitution. *Japan Line, Ltd.* v. *County of Los Angeles; Zschernig* v. *Miller*, 389 US 429 (1968)." (Ex. 12, J.E. 7a-7d, at 12-13.)

Clearly, on their face the claims for refund raise no "competitive balance" issue which would exist if only foreign-parent groups gained court relief from WWCR. The claims only address the inconsistency of worldwide apportionment (as imposed by California) with the separate accounting method used by the United States and foreign governments. The claims make no reference to actual or potential disparity of treatment between foreign-parent multinationals and domestic-parent multinationals. Nor is competitive balance between domestic-based and foreign-based multinationals a part of the one-voice analysis of this Court in *Japan Line*. FTB submits, therefore, that competitive balance was not raised in the claim for refund.

It is the settled law of the State of California that failure to exhaust administrative remedies by raising the specific issue in a timely filed claim for refund is a jurisdictional bar to pursuing that issue in court in a suit for refund of taxes. *Jimmy Swaggart Ministries* v. *Board of Equalization of the State of California, supra; A & M Records, Inc.* v. *State Board of Equalization*, 204 Cal.App.3d 358, 368 (1988). Because Colgate failed to raise competitive balance as a ground for refund in its claim, the issue is not properly before this Court.

b. "Competitive balance" is not a foreign Commerce Clause issue.

At Br. 45 Colgate charges error in the following analysis of the Court of Appeal at Pet. App. E, p. 61a:

"As we have seen, the President's statement, the two Secretary letters, and the two letters from the Justice Department attorneys show that the foreign commerce problem is essentially limited to foreign-parent groups and does not materially involve their domestic-parent counterparts. 'Competitive balance' for domestic corporations is not part of the 'foreign policy implications' issue. Therefore, the statement and letters from the executive branch officials do not constitute, either individually or collectively, an authoritative expression of the federal government that state application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries implicates foreign policy issues which must be left to the federal government."

The Court of Appeal's analysis is supported by the treatment of competitive balance concerns by the Executive Branch. As noted previously the Executive left the resolution of this issue to the states. See J.A. 20.

Further, the "one voice" analysis arises from such concerns as foreign retaliation, *Container*, at 194, *Japan Line*, at 450, or bona fide disputes over reconciling formulae, *Japan Line*, at 450. Colgate has cited no basis for such foreign concerns predicated on domestic competitive disadvantage. In fact, not one of the executive statements relied upon by Colgate asserts this as a foreign policy issue. Rather, competitive balance is asserted to be a

matter of "tax policy". J.A. 35, 48, 50. Clearly, the implications of a competitive disadvantage to United States-based multinationals is much more a matter of domestic concern than foreign concern. See *Container*, 194-195.

3. Colgate has furnished no factual record from which this Court can determine the comparative advantages and disadvantages of the application of WWCR to domestic-based groups while foreign-based groups were to be taxed on the basis of separate accounting.

As noted by this Court in *Container*, arm's length separate accounting may in some instances result in more serious double taxation than formula apportionment. *Id.*, at 191. WWCR also may result in less tax than the use of AL/SA. *Id.* at 188, n. 25. In the instant case Colgate has furnished no factual record which establishes that AL/SA would give foreign-parent groups an appreciable competitive advantage over domestic-parent groups subject to unitary apportionment. While the playing field may be bumpy, Colgate has not shown that it will be slanted in any particular direction.

III. EVEN IF COLGATE HAD PROPERLY RAISED THE ISSUE, THERE IS NO DORMANT FOREIGN COMMERCE CLAUSE REQUIREMENT FOR EQUAL TREATMENT OF U.S.-BASED AND FOREIGN-BASED MULTINATIONAL GROUPS WITH RESPECT TO WWCR.

Initially it must be stated that this issue, like Colgate's competitive balance issue, was not raised in

Colgate's claims for refund. Ex. 12, J.E. 7a-7d. Colgate does not even attempt to bring this issue under the "one-voice" test, but rather attributes it to " . . . basic principles of Commerce Clause analysis." Br. at 45. Accordingly, this issue is clearly outside the grounds raised in the claims for refund, and not properly before this Court. *Jimmy Swaggart Ministries, Inc.* v. *Board of Equalization of the State of California, supra.*

This issue also is not within the scope of the "Questions Presented" as stated at page i of Colgate's petition for review. This issue, which alleges direct violation of the Commerce Clause, is clearly outside the purview of Colgate's first question: "Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant commerce clause, may be found in congressional silence." Nor can this issue which Colgate asserts is "Wholly apart from Colgate's foreign policy-based contentions . . . ", Br. 45, be brought under Colgate's second question: "Whether WWCR as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the Foreign Commerce Clause." Pursuant to Rule 14.1(a) this issue should not be considered by this Court.

Further, as is the case with the competitive balance argument, even if this Court were to hold that combined reporting was invalid as to *Barclays* for income year 1977, Colgate has presented no record from which this Court can conclude the effect, if any, of such a decision on domestic-parent multinationals for the 1970-1973 tax years at issue in this case. For these years Colgate has established no record from which an impermissible level of inequality of treatment can be determined.

Additionally, in the proceedings below, the Court of Appeal declined to rule on this issue on the basis that it was not ripe for decision, stating further that " . . . this issue was not litigated below in any meaningful fashion, was not part of the trial court's decision, and consequently has not been briefed adequately here." Pet. App. at 66a, n. 12. These factors, coupled with the lack of a factual record as noted above, strongly indicate that this Court should decline to consider this issue. See *Yee* v. *City of Escondido*, 112 S.Ct. 1522, 118 L.Ed.2d 153 at 172 (1992): "Applying our analysis . . . to the facts of a particular case without the benefit of a full record or lower court determinations is not a sensible exercise of this Court's discretion."

Finally, even if this case could present the issue as it might arise in the future – with foreign-based groups using court-imposed AL/SA and domestic-based groups using WWCR, Colgate has presented neither a factual nor a legal record sufficient to warrant review of this issue.[8] Colgate cites no factual basis for its allegation that application of WWCR only to domestic-parent groups would cause a "diminution of free competition" or cause a "resulting competitive advantage to foreign-based multinational groups like *Barclays* and its affiliates." Br. 46. As

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[8] In the real world, a decision in favor of the taxpayers in *Barclays* under a one voice dormant Commerce Clause analysis would require California to tax members of foreign-based groups as if the federal AL/SA tax law had been imposed on California, with members of the domestic groups subject to the current California choice between WWCR and water's edge approach. The domestic groups might well come out ahead in these circumstances.

noted above in connection with Colgate's competitive balance argument, there is no record of the disparity in tax from the two methods to support Colgate's unequal treatment argument.

Colgate's legal argument also fails. *Kraft General Foods, Inc.* v. *Iowa Department of Revenue and Finance*, 112 S.Ct. 2365 (1992) was concerned with a state statute which facially discriminated *against* foreign commerce in favor of domestic commerce. In *Kraft* this Court was not faced with, and did not address the issue of discrimination in favor of some participants in foreign commerce as opposed to other participants in foreign commerce. Neither did this Court hold that absolute equality of treatment was required. *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318 (1977) also involved a statute which discriminated against out-of-state sales in favor of in-state sales. It was the discrimination in favor of local commerce which was the basis of this Court's determination that the statute was unconstitutional: "We hold only that in the process of competition no state may discriminatorily tax the products manufactured or the business operations performed in any other state." *Id.*, at 337. Neither of the federal decisions cited by Colgate supports its argument on this issue.

Finally, all of the cases relied upon by Colgate involved discrimination that was imposed by the state *statutory* scheme. In the instant case, however, California's WWCR method of taxation does not discriminate between foreign-based and domestic-based internationals. The possibility of discrimination can arise only if this Court invalidates a portion of California's taxing scheme. FTB submits that it would be anomalous for this

Court to create a discriminatory scheme through a decision in *Barclays* invalidating the tax as to foreign-based groups, and then find that the resulting system was discriminatory and in effect, overrule *Container* on the basis of the question that was reserved by that Court. If the "competitive balance" policy interests have any weight in the Commerce Clause analysis, it would be against issuing any decision (in favor of foreign-based groups) which would create any such competitive imbalance.

IV. IT IS TOTALLY INCONSISTENT FOR COLGATE TO RELY ON POST 1970-73 EVENTS TO SUPPORT ITS ARGUMENT OF UNCONSTITUTIONAL INTERFERENCE WITH FOREIGN POLICY AND THEN CONTEND THAT OTHER POST 1970-73 EVENTS WHICH NEGATE COLGATE'S CLAIMS DO NOT UNDERMINE ITS CASE.

Colgate is presented with a dilemma in this case. Because of the *Container* decision, it must acknowledge that there was no clear federal directive banning WWCR and no sufficient dormant Commerce Clause one voice factors against WWCR prior to 1983. See Br. 37-38. Also, because there has been no pre-emptive change in the federal law since *Container* and because the Executive Branch has never participated directly in this case, Colgate is required to rely on post-*Container* statements from members of the Executive Branch critical of WWCR to support its foreign policy argument under the one voice element. Suddenly, Colgate is faced with a new administration that does not furnish letters supporting its position, and in fact filed an amicus brief in *Barclays* stating:

"California's recent modifications of its tax system have brought that state's law into acceptable harmony with federal and international 'arm's length' tax practice." S. Gen. *Barclays* 10. Colgate's assertion that "*existing* United States foreign policy remains unalterably opposed to state's use of worldwide unitary combination", Br. 40 (emphasis in original), is totally without factual basis.

Colgate fails to recognize that ever since *Container* the Federal Executive Branch has taken a consistent tax policy position to encourage the WWCR states voluntarily to adopt water's edge legislation such as California's current law, with full competitive balance between foreign-based groups and domestic-based groups. See Br. 11. The Solicitor General has confirmed California's successful harmonization of its law with the federal practice. None of the Executive Branch documents which have led to this successful conclusion of the political process can now have any weight in supporting Colgate's assertion of invalidity for its California taxes for income years 1970 through 1973.

V. CONTRARY TO CLAIMS OF AMICI CHAMBER OF COMMERCE, ET AL., POSSIBLE DOUBLE TAXATION RESULTING FROM THE APPLICATION OF WWCR TO MULTINATIONAL CORPORATIONS DOES NOT RESULT IN THE TAXATION OF EXTRATERRITORIAL VALUES BY CALIFORNIA.

Amici Chamber of Commerce of the United States, et al., argue that *Container* should be overruled, contending that:

"The constitutional concern that states may be taxing value beyond their borders is implicated whenever multiple taxation occurs, without regard to the mathematical niceties from which the multiple taxation arose. Amicus Br. at p. 15.

"The Constitution is indifferent to how a tax was calculated, so long as the calculation does not result in taxation of out-of-state values. *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 444 (1940); cf. *Trinova Corp.* v. *Michigan Dep't of Treasury*, 111 S.Ct. 818, 831 (1991) (difference between methods of calculating tax 'is one of form and lacks constitutional significance'). One unmistakable indication of taxation of out-of-state values is that a corporation is twice taxed on precisely the same value. Whether it occurs with respect to income or property, such double taxation is unconstitutional. *Container*'s reasoning is therefore anomalous." Amicus Br. at p. 13.

Before countering this attack on *Container*, FTB notes that such an attack is completely outside the scope of the Court's review as established by the issues presented by the parties. Under Rule 14.1(a) it is not properly before the Court. See *United Parcel Service* v. *Mitchell*, 451 U.S. 56, 60, n. 2 (1981); *Bell* v. *Wolfish*, 441 U.S. 520, 532, n. 13 (1979); *Knetsch* v. *United States*, 364 U.S. 361, 370 (1970).

The error in amici's reasoning is that the fact of double taxation does not necessarily mean that the extraterritorial values are being taxed by California. As this Court noted in *Container*, "Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context

in which the double taxation takes place and the alternatives reasonably available to the taxing state." *Id.*, at p. 189.

The context of the instant case in which this issue must be examined is the comparison of the AL/SA method to the WWCR method. Double taxation will occur when WWCR taxes as California income a portion of income that is taxed under AL/SA by a foreign nation. However, extraterritorial values will be taxed by California only if that portion of income is not properly assigned to California. If that income is properly assignable to California, then the extraterritorial tax is imposed by the foreign nation under AL/SA, and not by California. Stated another way, if the differential income that is being taxed by California under WWCR as opposed to AL/SA is the income that is attributable to the failure of AL/SA to capture the "contributions to income resulting from functional integration, centralization of management, and economies of scale", *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 438 (1980), then there is no California taxation of extraterritorial value. In the context of this case, it is apparent that AL/SA is the device that more often results in extraterritorial taxation.

In *Container*, this Court made several comments which support the concept that WWCR is properly taxing transfers of value that are not captured under AL/SA. At page 181, this Court noted:

"First, appellant argues that its foreign subsidiaries are significantly more profitable that it is, and that the three-factor formula, by ignoring that fact and relying instead on indirect measures of income such as payroll, property, and

sales, systematically distorts the true allocation of income between appellant and the subsidiaries. The problem with this argument is obvious: the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place. Indeed, we considered and rejected a very similar argument in *Mobil*, pointing out that whenever a unitary business exists,

> 'separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.' 445 U.S., at 438 (citation omitted)."

Id., at p. 182:

> "Appellant and its foreign subsidiaries have been determined to be a unitary business. It therefore may well be that in addition to the foreign payroll going into the production of any given corrugated container by a foreign subsidiary, there is also California payroll, as well as other California factors, contributing – albeit more indirectly – to the same production. The mere fact that this possibility is not reflected in

> appellant's accounting does not disturb the underlying premises of the formula apportionment method."

And, *id.*, at p. 183:

> "The three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. It is therefore able to avoid the sorts of distortions that were present in *Hans Rees' Sons, Inc.*"

See also *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, ___ U.S. ___, 112 S.Ct. 2251, 2261 (1992), wherein this Court affirmed the superiority of combined reporting over geographical or transactional accounting.

Amici, in their brief sing paeans to AL/SA and to the avoidance of double taxation through the use of separate accounting, together with the mechanisms of IRC Section 482, competent authority and Advance Pricing Agreements (APA). Amici's arguments should be taken with a heaping tablespoon of salt. Initially it should be noted that most of amici's documentation is fairly recent although they advance AL/SA as a reasonable alternative to WWCR during the years in issue. The success of the administration of the arm's length method during the period here under consideration, the early seventies, is documented in the General Accounting Office (GAO) Report to the Chairman, House Committee on Ways and Means, September 30, 1981, which states:

> GAO reviewed current IRS examination data on 519 U.S. multinational corporations, each having assets over $250 million and each having

> engaged in transactions with their foreign subsidiaries. GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income for such transactions were based on a true arm's length price. *Id.* at ii.

Section 482 provides for a hierarchy of methods to be used in making these adjustments; in descending order, comparable uncontrolled transactions, resale price method, cost-plus method and, finally and least favored, any other method. The Report goes on to consider the methods used by the service in making the studied adjustments and found that 47 percent of the cases representing 86 percent of the total dollars adjusted were done by the fourth method of the hierarchy "any other method." *Id.* at 31. "Any other method" usually turns out to be a formula approach.

With respect to the current data on section 482, as of September 30, 1992, there were $14 billion in section 482 adjustments pending in the Appeals Division of the Internal Revenue Service (with an average sustain rate of 22%). GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives at 6, May 1993. The Report summarized the testimony before the Subcommittee on Oversight, House Committee on Ways and Means on the subject as follows:

> "The IRS Commissioner further testified that transfer pricing cases were inherently factual and subjective in nature. They required a great deal of cost, pricing, and market data about the taxpayer and its competitors and as a result, were extremely difficult, time-consuming, and

> costly to develop. At other times, we heard IRS officials and business representatives say that documenting and putting together a section 482 case required substantial resources from both IRS and the taxpayer involved. Both IRS and corporate taxpayers characterized the result of the adjustment process as unpredictable. *Id.* at 36.

GAO Testimony Before the U.S. Senate Committee on Governmental Affairs, Statement of Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, released on March 25, 1993, Appendix, at p. 45, notes the continuing problems with transfer pricing:

> "The challenges of section 482 cases will remain for at least two reasons. First, the growing influence of international forces on the U.S. economy will continue to increase the potential for underpayment of U.S. taxes through transfer pricing practices of multinational companies. This influence is demonstrated by the growing amount of merchandise exports of U.S. parent companies to their foreign affiliates, which increased from $6 billion in 1966 to $86 billion in 1989 and represented 24 percent of total U.S. merchandise exports in 1989. Second, while the new, temporary transfer pricing regulations have many promising features, they still require taxpayers and IRS examiners to collect great amounts of information and use considerable subjective judgment to compute arm's length prices."

Amici also urge the successes of competent authority in resolving double taxation issues. It should be noted that before competent authority comes into play there

must have been an audit adjustment either by the U.S. or a foreign taxing authority. The IRS report cited by amici states that competent authority's inventory averages around 250 cases (around 200 of these revolve around 482 issues). They close around 120 cases a year, of which 100 involve section 482. The tax dollars in dispute on the closed cases ranged from approximately $300 million to $540 million. As noted above, as of September 30, 1992, there were $14 billion in 482 adjustments pending in Appeals. Cases resolved by competent authority are indeed the tip of the AL/SA iceberg.[9] In this regard it also should be noted that the IRS audits slightly less than 3 percent of the universe of corporate taxpayers. June 1992, GAO Report on International Taxation, p. 32.

Clearly, the Federal government has bargained itself into what has turned out to be a costly, difficult-to-administer, unpredictable and time consuming system for allocating income among multinational businesses for national tax purposes.[10] Congress has demonstrated its

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[9] Regina Deanehan, IRS Assistant Commissioner (International) at a June 8, 1993, address before the International Fiscal Association, described "disturbing behavior" involving U.S. taxpayers who are paying additional taxes to foreign countries instead of seeking competent authority relief to resolve double taxation issues because they are wary of confronting foreign tax authorities. In such cases, the taxpayer "is asking the U.S. Treasury to underwrite [the taxpayer's] unwillingness to take on a foreign government." 2 Tax Management Transfer Pricing Report June 9, 1993, at 67.

[10] In addition to the accounting difficulties of adequately reflecting the transfers of value that occur in a multinational business, the facts of this very case are particularly illustrative of an additional reason for the inability of AL/SA to capture

unwillingness to saddle the states with the same system. FTB submits that in practice, this Court's observation in *Container* at 193, has proven to be particularly apt: "It would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." (Citation omitted.)

Finally, in addition to the complete failure of Colgate and Amici to present any valid reason for overturning *Container*, this Court has recognized that special considerations are present in cases such as this where the court is presented with issues that are within the ultimate power of Congress to resolve. In *Quill Corporation* v. *North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91, this Court was faced with a Commerce Clause issue related to North Dakota's use tax. After rejecting the North Dakota Supreme Court's conclusion that this Court's earlier decision in *National Bellas Hess, Inc.* v. *Department of Revenue of Illinois*, 386 U.S. 753 (1967), was unsound in view of later decisions, this Court stated:

> "Indeed, even if we were convinced that Bellas Hess was inconsistent with our Commerce Clause jurisprudence, 'the very fact [might] giv[e] us pause and counse[l] withholding our hand, at least for now. Congress has the

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transfers of value; Colgate denied that any such transfers took place (CT 4) and attempted to conceal the documents that evidenced the transfers, even in this litigation. CT 1937-1945, 1963-1969; FTB's Opening Brief in the Court of Appeal filed May 15, 1990, pp. 4-6. Separate accounting cannot reflect transfers of value that are concealed by the taxpayer.

power to protect interstate commerce from intolerable or even undesirable burdens.' (Citation omitted.) In this situation, it may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.' " (Citation omitted.) *Quill Corporation* v. *North Dakota, supra,* at 110-111.[11]

VI. IN VIEW OF THE UNIQUE FACTORS PRESENTED IN THIS CASE, THIS COURT SHOULD RESERVE THE QUESTION REGARDING RELIEF TO COLGATE, AND APPLY ANY DECISION REGARDING THE VALIDITY OF WWCR PROSPECTIVELY ONLY.

In *Harper* v. *Virginia Department of Taxation,* 509 U.S. ___, 125 L.Ed.2d 74, at 86 (1993), this Court adopted the following rule regarding retroactive application of its decisions:

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[11] See also the concurring opinion of Justice Scalia at 111-112:

> "I also agree that the Commerce Clause holding of Bellas Hess should not be overruled. Unlike the Court, however, I would not revisit the merits of that holding, but would adhere to it on the basis of stare decisis. (Citation omitted.) Congress has the final say over regulation of interstate commerce, and it can change the rule of Bellas Hess by simply saying so. We have long recognized that the doctrine of stare decisis has 'special force' where 'Congress remains free to alter what we have done.' (Citations omitted.) Moreover, the demands of the doctrine are 'at their acme . . . where reliance interests are involved.' " (Citation omitted.)

> "Beam controls this case, and we accordingly adopt a rule that fairly reflects the position of a majority of Justices in Beam: When this Court applies a rule of federal law to *the parties before it*, that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule." (Emphasis added.)

This Court by implication preserved the possibility of prospective rulings in those cases in which it reserved the question as to the parties now before the court. *Id.*, at 86-87, see also O'Connor dissent at 99.

A. Under Harper, Container precludes relief to Colgate in this case.

Under *Harper, Container* is controlling as to Colgate's claim for relief. The Colgate tax years 1970-73 predate the *Container* decision issued in 1983 by some ten or more years. The *Container* decision was applied by this Court to the parties before it. *Id.*, at 175, 197. Accordingly, this Court's *Container* holding that WWCR was constitutional in the face of a foreign Commerce Clause challenge is the rule of law applicable to this case under *Harper, supra,* and Colgate is not entitled to any relief.[12]

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[12] Colgate argued in its Reply Brief on its Petition for Certiorari to this Court, at 6, that FTB was contractually bound to apply relief on a retroactive basis. The paragraph of the Stipulation of Facts relied on by Colgate provides a computation only, in the event that it was determined that Colgate was entitled to a refund for the years set forth. J.A. 6. The stipulation was to facts

Additionally, the particular circumstances of this case mandate that any possible decision that WWCR is unconstitutional as applied to domestic-parent groups should not be applied to Colgate. Each of the grounds for unconstitutionality urged by Colgate arises from post 1973 events and changed circumstances arising after *Container* decision. Clearly, as this Court decided in *Container*, none of the events then considered by the Court was sufficient to constitute a violation of the foreign Commerce Clause. The events urged by Colgate to change the *Container* result (Secretary Brady's 1991 "clear directive" letter, J.A. 35, President Reagan's 1985 press statement, J.A. 7, or a "competitive imbalance" arising as a result of WWCR being found unconstitutional as to foreign-parent groups) are not circumstances that existed during the Colgate years. This case is not like *Harper* v. *Virginia Dept. of Taxation, supra*, where the unconstitutionality of the statute did not turn upon particular events but on a continuing discriminatory relationship without a time dimension. The statutes in *Davis* v. *Michigan Dept. of Treasury*, 489 U.S. 803 (1989) and *Harper* v. *Virginia, supra*, were unconstitutionally discriminatory by nature and

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only. The parties expressly reserved the right to the review of *any* question of law on appeal. J.A. 4. FTB raised the prospective-retroactive relief issue at the earliest next California procedural opportunity after this Court's decision in *James B. Beam Distilling Co.* v. *Georgia*, 501 U.S. ___, 115 L.Ed.2d 481 (1991), which indicated that if relief is given to the first taxpayer to raise a Constitutional issue, some form of retrospective relief must be given to all taxpayers who have perfected their claims.

operation, regardless of any time period or other independent factors. There was no particular event or series of events that brought about unconstitutionality.

Further, in *Harper, supra,* and *Davis, supra,* the discriminatory operation of the statutes was constant as to the groups of taxpayers involved. All Federal retirement earnings were taxed, all state retirement earnings were exempt. It was not a case such as this where some taxpayers will pay more and some will pay less under either method of taxation.

In this dormant Commerce Clause aspect of Colgate's argument, however, we are presented with a form of constitutionality that is not constant. Rather, Colgate urges what may be best termed a species of "transient" unconstitutionality, an unconstitutionality that arises, if at all, from the interaction of WWCR with independent events that exist within a particular time frame. For instance, if WWCR were to be declared invalid as a result of interference with foreign policy, there must be a foreign policy with which that interference occurs. If that policy has not come into being (see *Wardair* at 10-11 differentiating between aspirations and policy) or has ceased to exist (i.e., if the Federal Government were to enact a policy to adopt WWCR both at the national and subnational levels), then the interference would not exist. Likewise, if the alleged unconstitutionality stems from violation of a clear federal directive, then it is only after that directive has been promulgated and while it has preemptive effect that unconstitutionality exists. If the alleged invalidity is based on competitive imbalance or unequal treatment arising from 1994 court determinations involving foreign-based multinational businesses, it is

only while there is competitive imbalance or disparate treatment at a level which contravenes an existing policy that unconstitutionality occurs. This sort of "transient" unconstitutionality has a time and event factor not present in *Harper* v. *Virginia Dept. of Taxation, supra*. Because there has been no showing by Colgate that any of these events existed at all, much less in the relevant time period, Colgate should be denied relief and the question of retrospective operation should be reserved.

Finally, the fact that this case involves an issue arising under the Commerce Clause presents particular considerations that militate against overturning *Container*, even if this Court has some reservations concerning its viability under changed conditions. As noted by Justice Scalia in his concurring opinion in *Quill Corporation* v. *North Dakota, supra*, at 111-112:

> "We have long recognized that the doctrine of stare decisis has 'special force' where 'Congress remains free to alter what we have done'. (Citations omitted.) Moreover, the demands of the doctrine are 'at their acme . . . where reliance interests are involved.' " (Citations omitted.)

B. If this Court were to hold WWCR invalid on foreign Commerce Clause grounds, any relief should be prospective only.

In *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 (1971) this Court established the criteria for determining when a decision should not follow the normal rule of retroactive application, but should be applied prospectively only:

> "First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed. Second, . . . we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation. Finally, we [must] weig[h] the inequity imposed by retroactive application, for where a decision of this Court could produce substantial inequitable results if applied retroactively there is ample basis in our cases for avoiding the injustice or hardship by a holding of nonretroactivity." 404 U.S. at 106-107, (citations and internal quotations omitted), as quoted in *American Trucking Associations Inc.* v. *Smith*, 496 U.S. 167, 179 (1990).

Application of these criteria to this case makes it clear that any decision of this Court invalidating WWCR as applied to this taxpayer should be given prospective application only. Any such decision would meet the first element of the test in that it would overrule this Court's clear precedent upholding the constitutionality of this very tax in *Container*. With respect to the second element, the changes in California law cited at Br. 5, n. 4[13] have largely removed the continuing effects of any decision in this case. Certainly, there is absolutely no basis for any

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[13] FTB contests Colgate's assertion that the modification to California's WWCR was "in response to widespread opposition." The legislative changes culminated a political process involving many considerations.

foreign concern over California's method of taxation under the new law as applied to domestic-based groups. The matters addressed at p. 2a, App. A to Colgate's Supplemental Brief on Petition for a Writ of Certiorari refer only to the *Barclays* position. Certainly, prospective application of any decision would serve to quell any continuing concerns. With regard to the third element, the reliance interests are evident. As noted at Br. 38, approximately $1.2 billion in refund claims and $1.9 billion in assessments rest on the outcome of this case alone. The fiscal impact on the state of an adverse decision applied retrospectively would be devastating. Finally and most importantly, both California and taxpayers have relied on *Container* as affirming the validity of WWCR for the more than ten years after that decision, as well as for open years at the time *Container* was decided. For most of that period FTB is now precluded from assessing additional tax as to those taxpayers who reported under WWCR and would have owed more under AL/SA.[14] There are also taxpayers who would have owed less under AL/SA but have filed no refund claims in reliance on *Container*.

It should be further noted that Colgate's allegations of Commerce Clause infirmity in WWCR, if they existed at all, would arise from the potential conflict in our federal system of government between the power of the states to tax and the power of the federal government to conduct foreign affairs, Pet. App. A, 65a, rather than from

[14] The usual Statute of Limitations for assessment of deficiencies is four years under Revenue and Taxation Code Section 25663.

an unfairness or denial of due process in application of the tax to domestic-parent groups. This case does not present the same equities for retroactive relief as would a tax unfairly and discriminatorily extracted from all members of a defined group.

CONCLUSION

Colgate loses this case whether this Court upholds the *Wardair* analysis employed by the California Supreme Court in *Barclays*, or the dormant Commerce Clause analysis of *Container*. Under the *Wardair-Barclays* analysis, Congress has acted to allow WWCR, and Colgate's post-*Container* executive statements are irrelevant. Under the dormant Commerce Clause Test of *Container*, Colgate has failed to show either violation of a clear federal directive, or that any foreign policy has been interfered with in the domestic-parent context at any time. Moreover, Colgate has failed to show that the statements it relies on are related to the tax years 1970-73 at issue.

FTB respectfully requests that this Court affirm the decision of the California Court of Appeal. Alternatively, FTB requests that any decision which impinges on the constitutionality of WWCR as upheld in *Container* reserve the question as to relief to Colgate and be applied prospectively only.

Dated: January 19, 1994

Respectfully submitted,

DANIEL E. LUNGREN
Attorney General of the
State of California

LAWRENCE K. KEETHE
Supervising Deputy
Attorney General

JOHN D. SCHELL
Deputy Attorney General

Attorneys for Respondent

1515 K Street
P.O. Box 944255
Sacramento, California 94244-2550
(916) 324-5154

(25)

No. 92-1839

Supreme Court, U.S.
FILED
FEB 18 1994
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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REPLY BRIEF OF PETITIONER

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
FRANKLIN C. LATCHAM
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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REPLY BRIEF OF PETITIONER

INTRODUCTION

The central question in this case is whether worldwide combined reporting as applied to a U.S.-based multinational group frustrates federal foreign policy in violation of the Foreign Commerce Clause. Up to this juncture, the dispute over this question has focused on its substance—whether worldwide combined reporting offends federal foreign policy and, if so, whether that policy has been expressed with sufficient clarity to preclude California from requiring Colgate to report on a worldwide combined basis. Now, however, the Solicitor General has filed an *amicus* brief which attempts to direct the Court's focus away from the federal opposition to California's method.

Contrary to the position that the United States has previously taken in this case (*see* Pet. Br. 34-38),[1] the Solicitor General has pledged a new-found allegiance to respondent. The Solicitor General's about-face is based not on his view of the merits of Colgate's claim, but rather on his view that, in determining whether worldwide combined reporting violates the Foreign Commerce Clause, the appropriate inquiry is whether there was an articulated federal policy in effect during 1970-73, the tax years here at issue. Since such policy was allegedly unclear in 1970-73, Colgate's claim, in the Solicitor General's view, must fail. Undertaken without reference to any authority in the prior decisions of this Court, the Solicitor General's eleventh-hour repudiation of the long-standing views of the United States cannot be justified in terms of the legal principles that have governed—and that should continue to govern—dormant Foreign Commerce Clause analysis.

In addition, both the Solicitor General and respondent contend that, even if a decision is rendered in favor of Colgate, relief should be granted on a prospective-only basis. The contention is wholly without merit. Not only

[1] References to the Brief of Petitioner are denominated "Pet. Br." followed by a page reference.

is respondent procedurally barred from raising this issue before the Court, but this Court's precedents also dictate that Colgate be granted relief on a retroactive basis. Finally, neither the Solicitor General nor respondent has persuasively challenged the arguments raised by Colgate in its opening brief.

I. THE CONSTITUTIONALITY OF WORLDWIDE COMBINED REPORTING UNDER THE FOREIGN COMMERCE CLAUSE MUST BE EVALUATED IN LIGHT OF THE OVERALL EVIDENCE OF THE NATION'S FOREIGN POLICY, REGARDLESS OF THE TAX YEARS AT ISSUE

The Solicitor General, speaking for the United States, has put to rest any question whether federal policy is opposed to worldwide combined reporting: "In the present dispute, it is quite clear that federal law has long embodied a preference for the arm's length method . . .," SG Br. 17 (emphasis omitted),[2] and that "the executive branch since 1982 has opposed the States' application of WWCR to domestic as well as foreign corporations," *id.* at 26. Nor does the Solicitor General deny that such policy has been expressed with sufficient clarity to bar states from requiring taxpayers to report on a worldwide combined basis.[3] Rather, the Solicitor General's support of respondent in this case is explained largely by the fact that, in his view, Colgate sued *for the wrong tax years.*[4]

[2] Citations to the Brief for the United States as *Amicus Curiae* Supporting Respondent, filed by the Solicitor General in this case and in *Barclays*, will be referred to throughout this brief as "SG Br." followed by a page reference.

[3] While the Solicitor General purports to refrain from expressing the United States' view as to the compatibility of worldwide combined reporting with federal foreign policy (SG Br. 23 n.16), he acknowledges that the United States, in its prior briefs, has consistently taken the position that the Foreign Commerce Clause bars the states from requiring worldwide combined reporting because it is "contrary to the federal government's foreign commercial policy." SG Br. 21.

[4] To be sure, the Solicitor General also suggests that Colgate's claim fails because the Federal Government has not expressed its opposition to worldwide combined reporting as applied to a domestic-based taxpayer in terms of foreign policy. However, as discussed below (*see infra*, pp. 19-20), the Solicitor General's argument is without merit.

According to the Solicitor General, if only Colgate had sought relief for the tax years during which such federal foreign policy had become manifest, Colgate would have had a substantial claim. However, since such policy allegedly was unclear in 1970-73—the tax years here at issue—Colgate's claim, according to the Solicitor General, must fail.

As we demonstrate below, a coherent approach to the Foreign Commerce Clause question raised by this case requires that the constitutionality of worldwide combined reporting be evaluated in terms of the overall evidence of the nation's foreign policy regarding the method of taxation at issue, regardless of the particular tax years involved and regardless of the fact that the state has prospectively changed its taxing method.[5] On not one occasion has this Court ever looked to the year a tax accrued to determine the Federal Government's policy in analyzing the "one voice" test. Rather, this Court has uniformly looked to all of the evidence in the record before it of the policy of the Federal Government with respect to the method of taxation at issue. Moreover, the approach suggested by the Solicitor General would create an utterly illogical standard for adjudicating future controversies that would serve to undermine the very purpose of the Foreign Commerce Clause.

Finally, even if the Court were to adopt the Solicitor General's views as to the proper approach to this case, the record supports the conclusion that federal policy

[5] It is still unclear when the change in California law allegedly easing the burdens of worldwide combined reporting will finally take place. As enacted in September 1993, the effective date of S.B. 671 was January 1, 1994. However, legislation pending in California will delay the effective date of S.B. 671 to as late as November 30, 1994, for certain fiscal-year taxpayers. Cal. A.B. 791, 1993-94 Reg. Sess. (Jan. 27, 1994) § 3.

opposing worldwide combined reporting had been established by the years at issue here.

A. In Analyzing Whether a State Tax Violates the "One Voice" Test, Both This Court and the United States Have Consistently Looked to the Federal Government's Complete Course of Conduct as Evidence of Foreign Policy

In determining whether a state tax violates the "one voice" criterion of the Foreign Commerce Clause—because it "*either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive" (*Container*, 463 U.S. at 194 (emphasis in original))—the Court has always evaluated the constitutionality of the state tax in light of all of the evidence in the record regarding the foreign policy of the Federal Government. Thus, in *Japan Line*, the source of the Court's contemporary Foreign Commerce Clause doctrine limiting state taxing power, the Court examined the impact that California's tax had on the Federal Government's ability to "speak with one voice" in the years leading up to 1978, the date of the Court's decision, not as of 1970-72, the tax years at issue. *Japan Line*, 441 U.S. at 452-53 & nn.17-18.

Similarly, the Court in *Container* did not limit its "one voice" analysis to statements of the Federal Government made during 1963-65, the tax years at issue in that case. Rather, the Court looked for, but could not find in the record then before it, evidence of a course of foreign policy that indicated whether California's tax created an unconstitutional interference. *See Container*, 463 U.S. at 195-96. More recently, in *Itel*, the issue before this Court was the validity of a state tax affecting cargo containers used in international trade. The petitioner argued that in *Japan Line* the Federal Government had interpreted a 1956 Container Convention as prohibiting all domestic taxes on international cargo containers. However, this Court rejected the petitioner's argument and looked to later indications of the federal government's foreign policy. *Itel*, 113 S. Ct. at 1101. *See also*

Kraft, 112 S. Ct. at 2370-71 (same); *Wardair*, 477 U.S. at 9 (same).[6]

Like the Court, the United States—at least prior to the filing of its *amicus* brief here—has always looked to the overall evidence of the Federal Government's foreign policy in apprising the Court of its views on whether particular state taxes at issue preclude the Federal Government from "speaking with one voice." Thus in his *amicus* briefs filed in *Japan Line, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, 463 U.S. 1220 (1983), *Wardair*, and *Kraft*, the Solicitor General has consistently focused on the Federal Government's existing foreign policy as it has developed over the years—not just the foreign policy that may have been in effect during the tax years at issue—in analyzing the question whether the tax before the Court prevented the Federal Government from "speaking with one voice."[7] In addition, the Solicitor General in each of these prior briefs has relied upon the actions and statements of federal officials to establish the Federal Government's policy, as opposed to simply presuming that the most recent *amicus* brief itself establishes policy. *See supra*, n.7.

The Solicitor General argues that federal policy must be determined at the time a tax accrues because no

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[6] Prior decisions regarding the date as of which the law or federal government policy should be determined uniformly follow the rule of decision established almost two centuries ago in *United States v. Schooner Peggy*, 5 U.S. (1 Cranch) 103 (1801). Chief Justice Marshall explained that "in great national concerns" the Court must decide cases "according to existing laws," even if the laws intervene after a judgment and before decision on appeal. *Id.* at 110. This Court has consistently applied that rule whether the law at issue has been constitutional, statutory, judicial, or new policy of an executive department. *Thorpe v. Housing Authority*, 393 U.S. 268, 281-82 (1969).

[7] *See* Brief for the United States as *Amicus Curiae* at 13, 20-26, 28-30, *Japan Line* (No. 77-1378); Brief for the United States as *Amicus Curiae* at 2-3, 14, 16-17, *Chicago Bridge* (No. 81-349); Brief for the United States as *Amicus Curiae* at 3-30, 34-36, *Wardair* (No. 84-902) (Lexis); Brief for the United States as *Amicus Curiae* at 22, *Kraft* (No. 90-1918).

amount of creativity can overcome the overwhelming evidence in the record of a clear federal directive condemning the state method of taxation at issue here. Colgate has catalogued the unbroken stream of federal statements and actions opposing worldwide combined reporting as applied to both domestic and foreign corporations (Pet. Br. 34-38), the existence of which the Solicitor General himself is forced to concede (SG Br. 26). While the Solicitor General, for whatever reason, urges a *result* sustaining the tax, he cannot alone (nor does he attempt to) set a new policy regarding the method of taxation applied to Colgate for the 1970-73 tax years.[8] Quite simply, the Federal Government's policy toward worldwide combined reporting is evidenced by the entire federal course of conduct contained in the record before the Court. That entire course of conduct condemns application of worldwide combined reporting, as it existed prior to California's eleventh-hour revision of the method, to Colgate for the 1970-73 tax years before this Court.

B. The Solicitor General's Approach to the Issues in This Case Ignores Practical Realities and Will Serve to Undermine the Very Purpose of the Foreign Commerce Clause

The Solicitor General, in an extraordinary last-minute turnaround, has sought to distance himself from the approach he has taken in his earlier submissions, boldly asserting that "[o]ur prior briefs in this case were flawed." SG Br. 21. It is, however, the Solicitor General's newly concocted approach to the Foreign Commerce Clause, not the approach that he and the Court have taken in prior cases, that is "flawed." In fact, the established approach makes good sense and good law.

The appropriate time for determining the Federal Government's foreign policy should reflect the purpose of the constitutional requirement barring taxes that impair the

[8] In fact, given California's revision of the tax method at issue here, there is no need for the Federal Government to readdress its long-established policy.

ability of the Federal Government to "speak with one voice." Simply put, that purpose is to avoid embarrassment of the Federal Government in the conduct of its foreign commercial policy. The critical moment for determining when the Federal Government may be embarrassed by state taxes that undermine its foreign policy is the moment when those taxes have their economic "bite." It is at this moment that the levy's impact is felt most acutely. Consequently, the most logical time for ascertaining whether a tax frustrates federal foreign policy is the moment when the tax is definitively enforced by the state taxing authority, through judicial proceedings if necessary, not when the tax technically accrues under state law.

This straightforward reasoning underlies existing law and practice which looks to the time when a tax is definitively enforced as the proper time for determining whether the tax impairs the ability of the Federal Government to "speak with one voice." In contrast, the Solicitor General's suggestion that the Court look to foreign policy at the time a tax accrues would not only constitute a radical departure from the sound approach the Court and the Solicitor General have previously embraced, it would also lead to absurd results that would disserve the underlying purposes of the Foreign Commerce Clause.

Assume, for example, that a state tax affecting foreign commerce accrues during year 1, before the Federal Government has had a reasonable opportunity to evaluate the impact of the levy on federal foreign commercial policy. Assume further that the taxpayer challenges the constitutionality of the tax in year 2, informing the Federal Government of the taxpayer's view that the tax frustrates foreign policy. Finally, assume that over the next five years, as the case makes its way through the administrative and judicial process, the Federal Government articulates the firm opinion that imposition of the levy is incompatible with the conduct of federal foreign commercial policy. Under the Solicitor General's approach, if the state sought to enforce the tax in year 7, after judicial proceedings were complete and after the Federal Government had

firmly concluded that imposition of the tax frustrated federal foreign policy, the tax would nevertheless be sustained because the policy had not been clearly established in year 1 when the tax accrued.

The Solicitor General's approach cannot be squared with the purposes of the Foreign Commerce Clause. Plainly, the purposes of the Foreign Commerce Clause, as reflected in the "one voice" test, would be undermined by an approach that required the Court to ignore the total impact that imposition of a state tax has on federal foreign policy and to rest its judgment instead on a purely historical inquiry. It would indeed be perverse if the Foreign Commerce Clause were construed to sanction taxes whose existing application frustrates federal policy, merely because at some earlier time federal policy regarding such taxes had not been clearly articulated, while condemning taxes whose application is wholly consonant with federal policy, merely because at some earlier time federal hostility to such taxes had been clearly expressed.

Moreover, the Solicitor General's approach ignores economic, political, and diplomatic realities. As a practical matter, in many (if not in most) instances, it will take a number of years after a tax accrues for taxpayers and the Federal Government to determine whether, and the extent to which, state taxes concretely frustrate federal foreign policy. There is, in effect, a natural gestation period during which taxpayers assess the precise effect of a state tax upon their conduct of foreign commerce and the Federal Government assesses the impact of the tax upon its foreign policy concerns. To measure the compatibility of a state tax with the nation's foreign policy at the time of the tax's accrual rather than the time of its definitive enforcement would thus result in a constitutional mismatching of gross proportions.

C. A Federal Policy Opposing Worldwide Combined Reporting Had Been Established by the Tax Years at Issue

Finally, even assuming *arguendo* that the time for determining whether a state tax violates the "one voice" standard is when the tax accrues, Colgate must nevertheless prevail because federal policy opposing worldwide combined reporting had been established by the tax years at issue. The Solicitor General's argument to the contrary was evidently formulated without regard to the record in this case, or federal actions for tax years before 1982.

The record in this case is undisputed that, as of 1970-73, the Federal Government had a policy opposing states' use of worldwide combined reporting. The trial court made a specific finding to this effect, based on statements of the Federal Government relevant to the 1970-73 time period. Pet. App. F at 100a-02a. Hence even under the Solicitor General's approach to this case, California is barred from applying worldwide combined reporting to Colgate.

Moreover, the United States' own actions cannot be reconciled with the Solicitor General's newly adopted position that, prior to the 1980s, there was no federal policy opposing worldwide combined reporting. The United States in fact received a settlement payment on the basis that worldwide combined reporting was unconstitutional for the period 1975-78. *United States v. Alaska*, No. A87-328 (D. Alaska filed July 15, 1987).[9] It is un-

[9] That suit related to an increase in the Alaska tax burden of Husky Oil Company and a subsidiary. The United States was obligated to pay this increase under a cost-plus contract. Thus, the Solicitor General displays substantial unfamiliarity with the long-standing controversy over other states' use of worldwide combined reporting when he asserts that the United States is "not aware of any objections expressed by the affected taxpayers" in Alaska or Tennessee (SG Br. 28 n.22). The Department of Justice, which brought the Alaska suit on behalf of the United States, was certainly aware of disputes in Alaska. Indeed, there are a number of

seemly, to say the least, for the Federal Government to be repudiating a position on which it has relied to extract a monetary settlement from a sovereign state.

II. IF COLGATE PREVAILS IN THIS CASE, RELIEF MUST BE GRANTED ON A RETROACTIVE BASIS

A. Respondent Is Barred by State Law from Raising the Issue of Prospectivity

Respondent asks this Court to "apply any decision regarding the validity of WWCR prospectively only." Resp. Br. 42. Respondent raised the prospectivity issue *for the first time* at oral argument before the California Court of Appeal. Under California law, an issue raised for the first time in oral argument is deemed waived. *See, e.g., Kinney v. Vaccari*, 27 Cal. 3d 348, 356-57 n.6, 612 P.2d 877, 881 n.6, 165 Cal. Rptr. 787, 791 n.6 (1980); *Chatterjee v. Kizer*, 231 Cal. App. 3d 1348, 1366 n.4, 283 Cal. Rptr. 60, 70 n.4 (2d Dist. 1991); *Estate of Davis*, 38 Cal. App. 2d 579, 587, 102 P.2d 545, 545 (1st Dist. 1940). The California Court of Appeal therefore refused to entertain this issue at oral argument. *See* extracts from transcript of oral argument before the Court of Appeal reproduced in App. A.

This Court has held that it does not have jurisdiction over a federal question unless that question has been raised and pursued in a timely manner in state court proceedings. *See Michel v. Louisiana*, 350 U.S. 91, 97 (1955); *Williams v. Georgia*, 349 U.S. 375, 382-83 (1955). *See also Hulbert v. Chicago*, 202 U.S. 275 (1906); *Stembridge v. Georgia*, 343 U.S. 541, 547 (1952). "It is clear that this Court is without power to decide whether constitutional rights have been violated when the federal questions are not seasonably raised in accordance with the requirements of state law." *Edelman v. California*, 344 U.S. 357, 358 (1953). Because respondent has failed to raise the question of prospectivity

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other "affected taxpayers" who have expressed similar objections. *See Amicus Curiae* Brief on Behalf of the States of Alaska *et al.* (No. 92-1839) at 2, n.5.

in a timely manner in the state court proceedings, it is barred from raising the question before this Court.

B. Respondent Is Barred by Contractual Obligation from Raising the Issue of Prospectivity

Respondent is contractually bound to apply relief in this case on a retroactive basis. The precise language of the stipulation that respondent and Colgate entered into states that Colgate would be entitled to refunds if it was ultimately determined that respondent may not combine Colgate with its foreign subsidiaries in a single, worldwide group. *See* J.A. 6. California law is clear that a stipulation of counsel "must be construed by an *objective standard*" (*Consolidated Dock & Storage Co. v. Superior Court of L.A. County*, 18 Cal. App. 3d 949, 952, 96 Cal. Rptr. 254 (2d Dist. 1971) (emphaiss supplied)) and that "[i]t is immaterial that one of the parties had an undisclosed intention or belief as to what it meant" (*id.*). Respondent's previously-undisclosed belief that the stipulation "provides a computation only" (Resp. Br. 43 n.12) is contradicted by the plain language of that agreement which state law requires must govern. "It is up to the parties to state a stipulation clearly and properly if they intend to be bound by it . . . ." *Bemer v. Bemer*, 152 Cal. App. 2d 766, 771-72, 314 P.2d 114 (2d Dist. 1957).

Moreover, respondent's claim that it was entitled to raise *any* question of law on appeal, whatever the language in the stipulation, is belied by the well-established role of a stipulation in *narrowing* the issues to be tried. *Id.* at 771. Indeed, it was precisely because it was the subject of the stipulation that the parties did *not* try the issue regarding the amount of the refund to which Colgate was entitled.

C. Assuming *Arguendo* That the Prospectivity Issue Is Properly Before This Court, Respondent Has Presented No Valid Reason Why the Court's Ruling in *Harper* Requiring Retroactivity Should Not Be Applied in This Case

Even assuming that the prospectivity issue which respondent seeks to raise is properly before this Court, re-

spondent's argument utterly fails to demonstrate why the "'normal rule of retroactive application'" (*Harper v. Virginia Dep't of Taxation*, 113 S. Ct. 2510, 2518 (1993) (quoting *James B. Beam Distilling Co. v. Georgia*, 111 S. Ct. 2439, 2445 (1991))) should not apply in this case. Indeed, respondent's discussion of prospectivity reflects a profound confusion over the issues that bear on the merits of this case—issues that are irrelevant to the prospectivity issue—and those that bear on Colgate's entitlement to "meaningful backward-looking relief" (*McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31 (1990)), assuming it prevails on the merits. Colgate nevertheless addresses arguments that respondent raises under the rubric of "prospectivity" (Resp. Br. 42-49), even though some of them do not logically belong there.

First, respondent argues that, "[u]nder *Harper*, *Container* is controlling as to Colgate's claim for relief." Resp. Br. 43. Colgate agrees. *Harper* holds that when a rule of law has been applied to parties before the Court, that rule of law generally must be applied retroactively. Accordingly, the rule of law embodied in *Container* controls the outcome of this case. As Colgate has explained at length in its opening brief, however, the rule of law embodied in *Container*, viewed in light of the clear evidence of the Federal Government's opposition to worldwide combined reporting, requires that judgment be rendered in favor of Colgate. In short, there is no issue in this case about the prospective or retroactive application of *Container*.[10]

[10] Similarly, confusion is evident in respondent's suggestion that retroactive relief should not be awarded "under *Harper*" because this case involves "a species of 'transient' unconstitutionality" that arises from "the interaction of [worldwide combined reporting] with independent events that exist within a particular time frame." Resp. Br. 45. Because these events did not occur until after 1973, respondent argues, "Colgate should be denied relief and the question of retrospective operation should be reserved." Resp. Br. 46. Again, respondent has confused the substantive issue in this case with the question of prospectivity. In order to reach a decision on the merits in Colgate's favor, the Court must find that worldwide combined reporting has been unconstitutionally imposed upon Colgate. It is at that stage of the analysis that the question whether —and when—there was a federal foreign policy in place has a bearing on Colgate's claim. Once a determination of unconstitutionality has been made, however, the timing of the events that led to that determination has no bearing on the question whether that determination should be applied prospectively. *See infra* pp. 14-17.

Second, in its discussion of "prospectivity" respondent argues against overturning *Container* on *stare decisis* grounds in light of the fact that Congress is free to act in this area.[11] This argument is, of course, inapposite. Colgate has not suggested that this Court overturn *Container*. Rather, Colgate is asking this Court to apply *Container* to the factual record before it. *See supra* p. 12. Furthermore, respondent may have asked for too much. As this Court found in *Japan Line* when the County of Los Angeles raised a similar argument, "to say that California has created a problem susceptible only of congressional . . . solution is to concede that the taxation [at issue] is an area where a uniform federal rule is essential." *Japan Line*, 441 U.S. at 454.

Far from precluding relief, the Court strongly indicated in *Harper* that its decisions must be applied on a retroactive basis in all instances. To be sure, the Court in *Harper* was able to rest its decision on the narrower ground that any rule of law applied to the parties before the Court must be applied retroactively to other cases on direct review. Nevertheless, the Court's references in *Harper* to its lack of "constitutional authority . . . to disregard current law'" (*id.* at 2517 (quoting *American Trucking Ass'ns v. Smith*, 496 U.S. 167, 214 (1990) (Stevens, J., dissenting))) and the fundamental rule of "'retrospective operation'" (*id.* at 2516 (quoting *Kuhn*

[11] The fact that respondent raises this argument in the context of its discussion of prospectivity is ironic in light of Justice Scalia's recent statement that "[p]rospective decisionmaking is the handmaid of judicial activism, and the born enemy of *stare decisis*." *Harper*, 113 S. Ct. at 2522 (Scalia, J., concurring).

v. Fairmont Coal Co., 215 U.S. 349, 372 (1910) (Holmes, J., dissenting))), as well as its heavy reliance on *Griffith v. Kentucky*, 479 U.S. 314 (1987), requiring retroactive application of its decisions in criminal cases, leave little doubt that retroactive application of its decisions is constitutionally required in all cases. *Accord*, SG Br. 22.

D. Pursuant to *Chevron Oil*, Relief in This Case Must Be Granted on a Retroactive Basis

Both respondent and its *amici* [12] argue that any decision in favor of Colgate in this case should be applied on a prospective-only basis pursuant to the three-part test established by this Court in *Chevron Oil v. Huson*, 404 U.S. 97 (1971). This Court's decision in *Chevron Oil*, however, mandates that the decision herein be applied retroactively.

In *Chevron Oil*, this Court established the now familiar three-part test for determining the limited circumstances in which a party should be granted relief on a prospective-only basis. First, "the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied . . . or by deciding an issue of first impression whose resolution was not clearly foreshadowed." *Chevron Oil*, 404 U.S. at 106. Respondent argues that a decision in favor of Colgate in this case would require that this Court overrule *Container*, thereby abandoning clear past precedent. Such a suggestion is, of course, absurd. Far from requesting that this Court overrule *Container*, Colgate is in fact relying on the principles established in *Container* as the very cornerstone of its argument. Accordingly, a decision in favor of Colgate in this case would fail to meet the first criterion of the *Chevron Oil* test.

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[12] *See Amicus Curiae* Brief on Behalf of the States of Alaska, *et al.* (No. 92-1839); Brief of *Amicus Curiae* Litton Industries, Inc. *et al.*

The second part of the *Chevron Oil* test, which the Court need not address here,[13] requires that the Court "weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retroactive operation will further or retard its operation." *Chevron Oil*, 404 U.S. at 106-07. Respondent argues that the changes adopted by California to its worldwide combined reporting statutory scheme "have largely removed the continuing effects of any decision in this case." Resp. Br. 47. In making this argument, respondent ignores the fact that the central issue in this case has considerable continuing implications for a multitude of taxpayers and involves billions of dollars in tax liabilities, not only in California but also in other states. *See Amicus Curiae* Brief on Behalf of the States of Alaska, *et al.*[14] More importantly, the fact that the state had changed its law for the future did not affect this Court's view in *McKesson* that the state must provide "a meaningful opportunity to secure postpayment relief for taxes already paid pursuant to a tax scheme ultimately found unconstitutional." *McKesson*, 496 U.S. at 22.

The third part of the *Chevron Oil* test requires the Court to "weig[h] the inequity imposed by retroactive application" in order to avoid "'injustice or hardship'." *Chevron Oil*, 404 U.S. at 107. Respondent claims that it justifiably relied on this Court's decision in *Container* and retrospective application of an adverse decision would have a significant fiscal impact. Resp. Br. 48. In fact,

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[13] Inquiry into this part (and the third part) of the *Chevron Oil* test is obviated here because the threshold requirement of "overruling" or "novelty" is not satisfied. *Ashland Oil, Inc. v. Caryl*, 497 U.S. 916, 918 (1990).

[14] Moreover, even the Solicitor General has recognized that there is no guarantee that California's new legislation will remedy the past foreign policy interference. His brief at an earlier stage of these proceedings recognizes that issues "might arise in connection with enforcement of the State's new legislation." Brief for the United States as *Amicus Curiae* at 10, *Barclays Bank* (No. 92-1384).

respondent has been well aware of the change in circumstances that has occurred since the *Container* decision, including the clarification of the Federal Government's position on this issue. This, in and of itself, has given the state ample notice that its taxing scheme was in jeopardy and its reliance on *Container* unfounded.[15]

Moreover, this Court has never required that a state *know* of the unconstitutionality of its taxing scheme in order for relief from the imposition of such a scheme to be granted on a retroactive basis. As this Court stated in *Harper*, "the federal law applicable to a particular case does not turn on 'whether [litigants] actually relied on [an] old rule [or] how they would suffer from a retroactive application' of [a] new one." *Harper*, 113 S. Ct. at 2516 (quoting *Beam*, 111 S. Ct. at 2447). In short, *Chevron Oil* requires that this Court balance the equities at issue in this case and, in so doing, there is no precedent to suggest that the financial interests of a state should trump those of a taxpayer with respect to funds that a state has collected unlawfully.

Finally, both respondent and the Solicitor General argue that a violation of the "one voice" test is not the type of constitutional violation that merits retroactive relief. *See* Resp. Br. 48-49; SG Br. 28-30. However, this Court has clearly held that " 'the Due Process Clause of the Fourteenth Amendment obligates the State to provide meaningful backward-looking relief to rectify *any* unconstitutional deprivation.' " *Harper*, 113 S. Ct. at 2519 (quoting *McKesson*, 496 U.S. at 31) (emphasis supplied). Moreover, backward-looking relief is the only way in which the Constitution can discourage states from interfering in foreign policy matters. To limit relief to the

[15] Indeed, contrary to respondent's claim, the state has demonstrated its own doubts regarding the holding in *Container*. *See* Cal. Code Regs. tit. 18, § 25111(i)(5)(B)(i)(II) (1993) (regulation proposed in 1988, and final in 1989, to the effect that a water's-edge election may be revoked retroactively and election fee refunded upon "[a] final appellate level determination that application of the worldwide combined report method is *per se* unconstitutional").

future alone would encourage states to act with total disregard for federal foreign policy, secure in the knowledge that they could recede at the last possible moment and incur no adverse consequences.

III. NEITHER RESPONDENT NOR ITS *AMICI* HAVE RAISED ANY MEANINGFUL CHALLENGE TO THE ISSUES RAISED BY COLGATE IN ITS OPENING BRIEF THAT ARE AT THE HEART OF THIS CASE

Respondent has wholly failed to rebut Colgate's argument that Congress has not consented to worldwide combined reporting. Even the Solicitor General, who supports respondent in this case, finds himself unable to swallow respondent's position on congressional consent. SG Br. 16 n.10. There is simply no basis in this record for concluding that the exacting standard for finding congressional consent to state laws has been met—a standard "requiring that Congress 'manifest its unambiguous intent before a federal statute will be read to permit' state regulation" that would otherwise violate constitutional norms. *Northwest Airlines, Inc. v. County of Kent*, 62 U.S.L.W. 4103, 4108 n.19 (U.S. Jan. 24, 1994) (quoting *Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992)).

Respondent similarly fails to offer any meaningful response to Colgate's argument that the Foreign Commerce Clause demands equal treatment of U.S.-based and foreign-based multinational groups. Rather, respondent attempts to avoid the issue, arguing here for the first time that it was not properly raised in Colgate's claims for refund and therefore is not properly before this Court. Such an assertion is simply wrong. Colgate's claims for refund stated that "application of worldwide unitary combination to the [Colgate] group fails to meet constitutional standards under the due process and equal protection clauses of the United States and California Constitutions and the commerce clause of the United States Constitution." *See* Colgate claims for refund, Joint Exhibits 7a, 7b, 7c, and 7d at 11. This general statement clearly incorporates Colgate's equal-treatment argument. Respond-

ent also raises this argument with regard to the "competitive balance" issue, and the argument similarly fails.

Respondent argues, in addition, that "competitive balance" does not implicate foreign policy and therefore does not raise Foreign Commerce Clause concerns. Resp. Br. 27. In making this argument, however, respondent ignores the clear statements to the contrary cited in Colgate's opening brief, including the statement of the Secretary of State that issues of "competitive balance" are "an integral and important element of overall foreign policy." *See* Pet. Br. 43. Respondent also ignores the trial court's finding, based on the federal statements before it, that "[i]n our case, California's application of the unitary method of taxation . . . conflicts directly with the foreign policy of the federal government . . . ." Pet. App. F at 88a.

Respondent nevertheless asserts that "competitive balance" does not implicate typical "one voice" concerns such as "foreign retaliation" and "disputes over reconciling formulae." Resp. Br. 27. Contrary to respondent's assertions, however, the issue of "competitive balance" is one that has profound implications under the "one voice" test. The very purpose of the "one voice" test is to enable the Federal Government to present a uniform and coherent policy to foreign nations. *See Japan Line*, 441 U.S. at 448-49. It has been a consistent policy of the United States, both in its treaty negotiations and in its other dealings with foreign nations, to ensure a level-playing field for U.S.-based companies. It is hard to imagine a situation more destructive of the credibility of the United States in its quest to enforce this policy than to allow a renegade state's taxing scheme to disregard the concept of "competitive balance."

Respondent's *amici* add little to respondent's unsuccessful efforts to address Colgate's claims on the merits. Indeed, the Solicitor General's analysis of Colgate's "equal treatment" argument demonstrates his lack of familiarity

with, and profound misunderstanding of, the issues that are at the heart of this case. The Solicitor General analyzes Colgate's equal-treatment argument on the premise that Colgate is asserting a constitutional right to equal treatment of *foreign* and *domestic* commerce. He baldly asserts that "that cannot be the law," SG Br. 27 n.21, declaring that "the whole point of *Japan Line* is that taxing practices that are permissible with respect to domestic commerce are sometimes unlawful as applied to foreign commerce and/or foreign taxpayers." In fact, the "whole point"—and one that the Solicitor General has missed entirely—is that, insofar as here relevant, Colgate is not asserting the right to equal treatment of any *domestic* commerce in which it is engaged. Rather, the current issue of the constitutionality of worldwide combined reporting arises entirely out of Colgate's *foreign* commerce (*Container*, 463 U.S. at 188-89), and it is in connection with this foreign commerce that Colgate raises the issue whether the Commerce Clause forbids the states from preferring one form of "foreign" commerce over another.

This fundamental confusion over the nature of Colgate's business may well be responsible for the Solicitor General's unfounded assertion that the Federal Government's opposition to worldwide combined reporting as applied to U.S.-based taxpayers is based solely on issues of tax policy, not foreign policy, and therefore Colgate's Foreign Commerce Clause argument fails. SG Br. 26-27. The presumption behind the Solicitor General's argument is that tax policy necessarily is concerned only with domestic issues. This Court's Foreign Commerce Clause jurisprudence, however, does not turn on mere semantics (that is, whether the Federal Government uses the phrase "tax policy" as opposed to "foreign policy") but rather analyzes the concerns underlying the Federal Government's position. As demonstrated in Colgate's opening brief, there is no question that the Federal Government's opposition to California's taxing method as applied to U.S.-based taxpayers was founded upon concerns relating

to that taxing method's impact upon the nation's foreign commercial and economic policy. *See* Pet. Br. 40-42.[16]

CONCLUSION

For the reasons set forth in our opening brief and in this reply brief, the judgment of the California Court of Appeal should be reversed.

Respectfully submitted,

JAMES P. KLEIER
Counsel of Record
WALTER HELLERSTEIN
PRENTISS WILLSON, JR.
CLARE M. RATHBONE
FRANKLIN C. LATCHAM
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000
Counsel for Petitioner

Dated: February 18, 1994

[16] Indeed, the Solicitor General's position is contradicted by evidence that he himself presents. In 1982, the United States filed a brief *amicus curiae* in *Chicago Bridge*, a case involving the imposition of worldwide combined reporting on a domestic-based taxpayer. The tax years at issue in *Chicago Bridge* were 1969-74 and therefore overlap the years at issue in this case. According to the Solicitor General himself, not only were "the government's criticisms of the worldwide method . . . couched in constitutional terms" but also "the government's opposition . . . extended to cover the method's application to domestic corporations with foreign subsidiaries." SG Br. 8. This admission by the Solicitor General clearly contradicts his own assertion that while "the executive branch since 1982 has opposed the State's application of WWCR to domestic as well as foreign corporations" (SG Br. 26), that opposition has "not asserted . . . that application of WWCR to domestic taxpayers interferes with the federal government's conduct of foreign relations." *Id.*

APPENDIX A

Extract from Transcript of Oral Argument Before the Court of Appeal

MR. SCHELL: Your honor, I would like to either by subsequent written request or oral request that the court take judicial notice of the State of California's Controller's Financial . . . General Purpose Financial Statements for the 1989-90 fiscal year, in which the Controller gives an estimate of the tax impact of this case with respect to the prospectivity argument, that tax impact . . .

P.J. PUGLIA: What possible effect could that have upon our decision?

MR. SCHELL: Just with respect to the *James B. Beam* retroactive/prospective argument, the equities, it . . . the tax impact is stated in the Controller's report . . .

MR. KLEIER: And if we can state our objections. This issue was obviously not before the trial court, and it is too late to present the issue for the first time on appeal, particularly because it would require findings of fact on the hardship issue. But to raise that issue . . .

P.J. PUGLIA: I think counsel is correct.

In the Supreme Court

OF THE

United States

Supreme Court, U.S.
FILED
FEB 14 1994
OFFICE OF THE CLERK

OCTOBER TERM, 1993

No. 92-1384

BARCLAYS BANK PLC,
Petitioner,

VS.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

No. 92-1839

COLGATE-PALMOLIVE COMPANY,
Petitioner,

VS.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

PETITIONERS' OPPOSITION TO CALIFORNIA LEGISLATURE'S MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

JOANNE M. GARVEY
Counsel of Record for Barclays Bank PLC
HELLER, EHRMAN, WHITE & MCAULIFFE
333 Bush Street
San Francisco, CA 94104-2878
(415) 772-6000

JAMES P. KLEIER
Counsel of Record for Colgate-Palmolive Company
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

BOWNE OF SAN FRANCISCO, INC. • 345 SANSOME ST. • S.F., CA 94104 • (415) 362-2500

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On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

PETITIONERS' OPPOSITION TO CALIFORNIA LEGISLATURE'S MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Petitioners Barclays Bank PLC ("Barclays") and Colgate-Palmolive Company ("Colgate") hereby oppose the California Legislature's Motion for Leave to File Brief Amicus Curiae.[1] The California Legislature's motion should be denied because (1) the brief is an improper second brief of a party, the State of California, whose interests are already adequately represented by Respondent, and (2) there is no evidence before this Court that the California Legislature authorized the filing of an amicus brief.

It is self-evident that a party to a dispute may not file an amicus brief on its own behalf. Thus, in *United States v. Smith*, the U.S. District Court denied the U.S. Sentencing Commission, an agency of the federal government, permission to appear as amicus because the U.S. Government was already a party to the dispute. *United States v. Smith*, 686 F. Supp. 847, 853 n.9 (D. Colo. 1988). The court stated that "[a] clear precondition of appearing as an amicus curiae . . . is that the movant not be a party to the dispute at issue."

Here Respondent and the California Legislature are both arms of the State of California. The State of California's designated representatives are already before this Court. The California Legislature vested Respondent with the power and duty of enforcing California's tax upon corporations in civil actions and designated the California Attorney General as Respondent's counsel. Cal. Rev. & Tax. Code §§ 19371-19372, 19382-19389 (West Supp. 1994). When the Attorney General appears, the State of California is in court. *California and Northern Ry. v. State*, 1 Cal. App. 142, 144 (1905).

Moreover, the interests of the California Legislature and Respondent in this case are the same. The California Legis-

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[1] There have been no changes to the Rule 29.1 Statements in the above referenced consolidated case since the Briefs of the Petitioners were filed with this Court.

lature alleges that its interest is to represent California's "power to enact legislation to impose tax." However, the California Attorney General, as the State's chief law enforcement officer, represents all the rights and interests of the State of California in all civil tax matters, including these cases. Cal. Gov't Code § 12511 (West 1992); *People v. Birch Securities*, 86 Cal. App. 2d 703 (1948), *cert. denied*, 336 U.S. 936 (1949). Respondent's power to collect and defend a disputed tax embodies California's power to tax; these powers cannot be wrenched apart. The California Legislature's brief amicus curiae is an improper second appearance by the State of California that subverts this Court's briefing rules. S. Ct. Rules 24, 25, 33 and 37.

Even if the California Legislature were a separate party, its brief would be inappropriate. When the interests of an amicus are adequately represented, its brief is unnecessary and unduly burdens the Court. S. Ct. Rule 37.1; *see, e.g., In re Oskar Tiedemann and Co.*, 289 F.2d 237, 240 n.5 (3d Cir. 1961); *United States v. Andrews*, 1983 WL 18974 (N.D. Ill. 1993) (mem.). The California Attorney General has been defending the State's sovereign taxing powers since these cases began and the California Legislature has never asserted that the Attorney General's representation was inadequate.

There are limited circumstances when a second branch of government has been allowed to file as an amicus: when a case may impact a legislative body's law making procedures, *see, e.g., Yip v. Pagano*, 606 F. Supp. 1566 (D.N.J. 1985), *aff'd*, 782 F.2d 1033 (3d Cir. 1986); or when its position in the case was clearly at odds with the other governmental entity, *see, e.g., New York v. Uplinger*, 467 U.S. 246, 247 n.1 (1984); *United States v. Louisiana*, 751 F. Supp. 608 (E.D.L.A. 1990); *Atkins v. United States*, 556 F.2d 1028 (Ct. Cl.), *cert. denied*, 434 U.S. 1007 (1977). Neither exception is applicable here. The California Legislature has

identified no special legislative procedure that is in jeopardy. Its brief does not advocate any positions contrary to Respondent's; it merely echos Respondent's arguments.

In addition, there is no evidence that the brief filed with the Court is an authorized position of the California Legislature. Under California law, the Legislative Counsel is forbidden to appear in court proceedings without the prior approval either by resolution of the Joint Rules Committee or by concurrent resolution of both houses of the Legislature.[2] Cal. Gov't Code § 10246 (West 1992). The brief to be filed by the California Legislative Counsel contains neither an assertion of such authorization nor any other evidence that the California Legislative Counsel has the authority to speak for the California Legislature. Petitioners have diligently searched the minutes of the Joint Rules Committee and the Official Journal of the Legislature and have twice requested a copy of any such authorization from Legislative Counsel. *See* Appendices A and B. No authorization has been located. Accordingly, there is no basis for this Court to conclude that the brief filed with movant's motion is an authorized representation of the views of the California Legislature.

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[2] An exception arising upon termination of the Joint Rules Committee is not applicable here.

For the foregoing reasons, we respectfully request that the Motion for Leave to File Brief Amicus Curiae filed by the California Legislative Counsel on behalf of the California Legislature be denied.

Respectfully submitted,

JOANNE M. GARVEY
Counsel of Record for
Barclays Bank PLC
HELLER, EHRMAN, WHITE &
MCAULIFFE
333 Bush Street
San Francisco, CA 94104-2878
(415) 772-6000

JAMES P. KLEIER
Counsel of Record for
Colgate-Palmolive Company
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

APPENDIX A

[LETTERHEAD]

January 14, 1994

VIA FACSIMILE
Bill S. Heir
Deputy Legislative Counsel
State Capitol, Suite 3021
Sacramento, CA 95814-4996

Barclays Bank PLC v. Franchise Tax Board

Dear Bill:

In your conversation with Jim Kleier and me, you mentioned that you had received authorization from the Joint Rules Committee. Could you please send us a copy of the resolution or other action, either by the Joint Rules Committee or by the Legislature? It is my understanding that under the Government Code action by the Joint Rules Committee as a committee is required and that such action would be taken in an open meeting. The other alternative is, of course, a concurrent resolution by both houses of the Legislature. We have been unable to find evidence of either. Accordingly we would appreciate copies.

Very truly yours,

Joanne M. Garvey

cc: James Kleier

APPENDIX B

[LETTERHEAD]

February 11, 1994

VIA FACSIMILE
Bill S. Heir
Deputy Legislative Counsel
State Capitol, Suite 3021
Sacramento, California 95814-4996

Barclays Bank PLC v. Franchise Tax Board;
Colgate-Palmolive v. Franchise Tax Board

Dear Mr. Heir:

On January 14, 1994 I wrote you to request evidence of authorization for the Legislative Counsel's office to file an amicus curiae brief on behalf of the California Legislature in the *Barclays* and *Colgate-Palmolive* cases. Under the Government Code, such authorization would require either vote at an open and public meeting of the Joint Rules Committee or a concurrent resolution by both houses of the Legislature during open session. We have continued to search but have been unable to find evidence of either. I renew my request, also made on behalf of James Kleier, Counsel for Colgate, for a copy of the resolution or other action which permits the appearance of the Legislative Counsel in either of these cases.

Very truly yours,

Joanne M. Garvey

cc: James Kleier

Supreme Court, U.S.
FILED
FEB 16 1994
OFFICE OF THE CLERK

IN THE
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OCTOBER TERM, 1993

No. 92-1384

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FRANCHISE TAX BOARD,
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Respondent.

**On Writ of Certiorari To The
Court Of Appeal Of The State Of California
In And For The Third Appellate District**

**SUPPLEMENTAL BRIEF OF
PETITIONERS' IN OPPOSITION TO CALIFORNIA LEGISLATURE'S
MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE**

On February 16, 1993 Petitioner Barclays Bank PLC ("Barclays") received a copy of a letter from the Chairman of the Joint Committee on Rules dated December 20, 1993 purportedly authorizing the Legislative Counsel to file a brief in these cases on behalf of the California Legislature.[1/] Appendix A. However, the Chairman of the Joint Rules Committee may not act on behalf of the committee without the authorization by two thirds of the committee membership at an open and public meeting. Cal. Gov't Code §§ 9027, 9028, 9917 (West 1992). No evidence of such authorization was produced. The type of authorization specifically required under Section 10246 of the California Government Code is not before this Court. Thus, there is still no basis for this Court to conclude that the brief filed with movant's motion is an authorized representation of the views of the California Legislature.

Barclays and Colgate-Palmolive Company ("Colgate") hereby renew their opposition to the California Legislature's Motion for Leave to File Brief Amicus Curiae.

Respectfully submitted,

Joanne M. Garvey
Counsel of Record for
Barclays Bank PLC
HELLER, EHRMAN, WHITE & MCAULIFFE
333 Bush Street
San Francisco, CA 94104-2878
(415) 772-6000

1/ There are no changes to the Rule 29.1 Statements in the above referenced consolidated case since the Briefs of the Petitioners were filed with this Court.

James P. Kleier
Counsel of Record for
Colgate-Palmolive Company
MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

Jack I. Horton
Chief Deputy

James L. Ashford
Harvey J. Foster
John T. Studebaker
Daniel A. Weitzman

David D. Alves
John A. Corzine
C. David Dickerson
Robert Cullen Duffy
Robert D. Gronke
James A. Marsala
Robert G. Miller
Verne L. Oliver
Tracy O. Powell II
Marguerite Roth
Michael H. Upson
Christopher Zirkle
Principal Deputies

State Capitol, Suite 3021
Sacramento, CA 95814-4996
(916) 445-3057
Telecopier (916) 322-0769

Legislative Counsel of California

BION M. GREGORY

Gerald Ross Adams
Martin L. Anderson
Paul Antilla
Charles C. Asbill
Joe J. Ayala
Raneene P. Belote
Lara K. Bierman
Diane F. Boyer-Vine
Ann M. Burastero
Eileen J. Buxton
Gwynnae L. Byrd
Sarajane Culbertson
Emilie Cutler
Ben E. Dale
Jeffrey A. DeLand
Clinton J. deWitt
Frances S. Dorbin
Maureen S. Dunn
Sharon R. Fisher
Clay Fuller
Patricia R. Gates
Debra Zidich Gibbons
Shira K. Gilbert
Alvin D. Gress
Maria Hilakos Hanke
Jana T. Harrington
Baldev S. Heir
Thomas R. Heuer
Ruben L. Iniguez
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Deputies

Sacramento, California
February 15, 1994

Heller, Ehrman, White & McAuliffe
Attorneys
333 Bush Street
San Francisco, CA 94104-2878

Attention: Joanne M. Garvey

Barclays Bank PLC v. Franchise Tax Board;
Colgate-Palmolive v. Franchise Tax Board

Dear Ms. Garvey:

Pursuant to the request in your letter dated February 11, 1994, to Mr. Heir, we have enclosed a copy of the letter memorializing the authorization of the Joint Committee on Rules for this office to represent the Legislature, as amicus curiae, in the above-referenced cases.

Very truly yours,

Bion M. Gregory
Legislative Counsel

Jack I. Horton
Chief Deputy

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Enclosure

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Sacramento, California
December 20, 1993

Mr. Bion M. Gregory
Legislative Counsel
State Capitol, Suite 3021
Sacramento, California 95814-4996

Dear Mr. Gregory:

Pursuant to Section 10246 of the Government Code, your office is hereby authorized to represent the Legislature, as amicus curiae, in the cases of Barclays Bank PLC v. Franchise Tax Board of California (No. 92-1384) and Colgate-Palmolive Co. v. Franchise Tax Board of California (No. 92-1839) before the United States Supreme Court. The purpose of this representation will be to advise the Court of the development of California's unitary tax law in response to communications from the federal government and the United Kingdom.

Sincerely,

JOHN L. BURTON
Chairman, Joint Committee on Rules

cc:

Honorable Willie L. Brown, Jr.,
Speaker of the Assembly
Honorable David Roberti,
President pro Tempore of the Senate
Honorable James L. Brulte
Honorable Ken Maddy

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Nos. 92-1284 and 92-1639

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In the Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK, PLC, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

COLGATE-PALMOLIVE COMPANY, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

ON WRITS OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING RESPONDENT

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

MALCOLM L. STEWART
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

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QUESTIONS PRESENTED

The United States will address the following questions:

1. Whether California's application of worldwide combined reporting (WWCR) to a foreign-controlled multinational corporation during tax year 1977 impaired the federal government's conduct of international commercial policy and therefore violated the Foreign Commerce Clause of the Constitution.

2. Whether California's application of WWCR to a domestic multinational corporation during tax years 1970-1973 violated the Foreign Commerce Clause.

3. Whether the Fourteenth Amendment to the Constitution requires California to provide a refund remedy in the event that the taxes at issue are determined to have been unlawfully imposed.

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In the Supreme Court of the United States

OCTOBER TERM, 1993

No. 92-1384

BARCLAYS BANK, PLC, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

No. 92-1839

COLGATE-PALMOLIVE COMPANY, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

ON WRITS OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING RESPONDENT

INTEREST OF THE UNITED STATES

The Constitution confers upon Congress the power to "regulate Commerce with foreign Nations" (Art. I, § 8, Cl. 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties" (Art. II, § 2, Cl. 2). The United States has a substantial interest in cases that address the constitutional allocation of authority over matters affecting foreign commerce and foreign relations. These consolidated cases present such issues. At the Court's invitation, the United States filed

a brief amicus curiae in No. 92-1384 at the petition stage.

STATEMENT

Different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, required to report income from its transactions with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal Revenue Code and in the many bilateral tax treaties to which the United States is a party (92-1384 Pet. App. H43).[1] The separate accounting method is also employed by most other nations for both domestic and international purposes.

During the tax years at issue in these cases,[2] California employed a different method of allocating corporate income known as "worldwide combined reporting" (WWCR). Under the California tax provisions then in effect, the State generally treated parents, subsidiaries and affiliates engaged in a unitary business as a single entity for tax purposes, pooled their global income, and allocated a portion of that combined income to California based upon a multi-factor formula.[3] See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 162-163 (1983).

[1] There are, of course, provisions of the Internal Revenue Code designed to forestall potential abuses of the separate accounting method. See, *e.g.*, 26 U.S.C. 482.

[2] No. 92-1384 involves tax year 1977. No. 92-1839 involves tax years 1970-1973.

[3] Under legislation enacted in 1986 (effective in 1988), California provided all corporations with a "water's edge" alternative to WWCR. See Cal. Rev. & Tax. Code § 25110 (West 1992); 92-1384 Pet. App. B4 n.2. In general, the "water's edge" method permits a taxpayer to report its income separately from the income of its foreign parents or affiliates. This case does not directly consider

Petitioners in these cases contend, *inter alia*, that the former California taxing scheme violated the Foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity [was] essential, and prevent[ed] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citations and internal quotations omitted). Proper resolution of this claim, we believe, requires a thorough understanding of the development of the federal government's policy regarding the States' use of WWCR.

1. Significant controversy over the States' use of WWCR first arose during the late 1970's when the Senate debated the United States-United Kingdom Tax Convention. The treaty was initially signed on December 31, 1975. Convention for Avoidance of Double Taxation, December 31, 1975, United States-United Kingdom, 31 U.S.T. 5670, T.I.A.S. No. 9682. The chief concession made by the British government was to reduce significantly the discriminatory impact of U.K. tax provisions regarding dividends paid by U.K. corporations. This provision was given an effective date of January 1, 1975, and it was expected to result in very substantial tax refunds to U.S. investors.

Within the United States, controversy over the treaty centered chiefly on Article 9(4). 31 U.S.T. 5677. As originally drafted, this provision appeared to bar the States' application of WWCR even to U.S. corporate parents with U.K. subsidiaries or affiliates. Apparently

or address the "water's edge" method of taxation because it concerns tax years that preceded California's adoption of that method.

On September 10, 1993, California enacted legislation to remove the fee the State previously had imposed on corporations that elected "water's edge" treatment under the 1986 legislation and also to remove the regulatory authority under which respondent could disregard a "water's edge" election and require a corporation to report its income on a worldwide basis. See Cal. S.B. 671, §§ 16, 23, 24, 26 (1993). Under this new legislation, all corporations subject to tax in California may now freely elect taxation under the "water's edge" method.

so broad a limitation had not been intended, and in response to the States' objections the U.S. and U.K. exchanged notes making clear that the States were barred from applying WWCR only in determining the tax liability of U.K.-controlled corporations. See *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations,* 95th Cong., 1st Sess. 305-306 (*1977 Hearings*) (1977) (Treasury Department Memorandum). So modified, the treaty was transmitted to the Senate by President Ford on June 24, 1976. 122 Cong. Rec. 20,348 (1976).

Even after this revision, individuals both inside and outside the Senate continued to express a wide range of objections to Article 9(4). Restrictions on the States' use of WWCR were said to constitute an improper interference with state autonomy. See, *e.g.,* 124 Cong. Rec. 18,427 (1978) (Sen. Stevens). Other Senators took the less sweeping position that any federal limitations on the States' taxing powers should be effected by legislation rather than through an international agreement negotiated by the executive branch alone. See, *e.g., id.* at 18,417 (Sen. Church); *id.* at 18,423 (Sen. Kennedy). Some participants, chiefly state taxing officials, argued that the arm's length method was unworkable and subject to manipulation by corporate taxpayers. See, *e.g., ibid.*; *1977 Hearings* 69 (prepared statement of the National Association of Tax Administrators). Opponents of the provision warned that the treaty would establish a dangerous precedent, and that the States' freedom to apply WWCR to the corporations of other countries would quickly be negotiated away. Senator Church led the opposition in the Senate, offering a reservation that would render Article 9(4) inapplicable to political subdivisions. See 124 Cong. Rec. 18,416 (1978).

Those who opposed the Church reservation (and supported the treaty with Article 9(4) included) countered with a variety of arguments. Advocates of Article 9(4) relied in substantial part upon the contention that the

arm's length approach provided a superior method for distinguishing foreign from domestic income. In a letter to the head of the California Franchise Tax Board dated February 15, 1977,[4] Secretary of the Treasury Blumenthal stated that "[t]he unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country." The letter explained that "[u]nder unitary apportionment, if the profit rate of a foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise." Blumenthal went on to state that "it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary," and argued that California's use of an apportionment method different from "the internationally accepted approach" would often lead to double taxation. The Secretary also stated that "[t]he unitary system imposes a substantial compliance burden on multinational corporations" and that the government was "aware of cases where this burden has discouraged foreign investment in the United States." The letter concluded: "For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable."

Treasury officials also emphasized, however, that the provision's impact on the States should be small because the treaty applied only to U.K.-controlled corporate taxpayers, leaving the States free to employ WWCR in taxing the income of corporations controlled by the nationals of other foreign countries. Thus, Assistant Secretary of the Treasury Laurence N. Woodworth explained that un-

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[4] Secretary Blumenthal's letter is reprinted in *1977 Hearings* 104-105.

der Article 9(4), "if the U.K. corporation is itself controlled by, say, a New York corporation, or by a Dutch corporation, California may take into account the income and expense of the entire group." *1977 Hearings* 35. Opponents of the Church reservation also emphasized the closely related argument that Article 9(4) should be viewed not in isolation, but as a necessary quid pro quo for substantial concessions made by the British. Secretary Blumenthal reminded the head of the California Franchise Tax Board that "a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, particularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom." *1977 Hearings* 104. In a subsequent letter to state Governors dated April 28, 1978, the Secretary sounded a similar theme, stating: "I realize that the merits of the unitary method can be debated. My purpose in writing is not to enter that debate but simply to note that the treaty restriction on this method represents a narrowly drawn and relatively minor concession, by any measure, in relation to the overall balance of benefits in the treaty." Letter from the Secretary of the Treasury to State Governor 2 (Apr. 28, 1978). A Treasury Department memorandum, responding to objections to Article 9(4) raised in testimony before the Senate Foreign Relations Committee, contested the assertion that "every treaty country will obtain the same provisions as the United Kingdom." The memorandum responded that "renegotiation of our complete treaty network will not occur for several years; and the Treasury Department will agree to the provision only in the context of a treaty beneficial to the United States." *1977 Hearings* 305.[5]

[5] On the final day of floor debate, Senator Javits relied heavily on this representation, stating that "[i]f the treaty is approved, Treasury will consider the inclusion of similar provisions in other treaties, but only in return for commensurate concessions on the other side." 124 Cong. Rec. 18,657 (1978). Senator Javits had previously characterized Article 9(4) as "but a part of a larger whole which is of great interest and of great importance to the United States," and as "a concession which we have made to the United Kingdom." 124 Cong. 18,418 (1978). Other Senators expressed similar views, opposing the Church reservation on the ground that the treaty *as a whole* would benefit the United States, and that acceptance of the Church reservation would imperil British acceptance of the accord. See *id.* at 18,652-18,653 (Sen. Hayakawa); *id.* at 18,669 (Sen. Dole).

On June 23, 1978, the Senate voted 44-34 to reject the Church reservation. 124 Cong. Rec. 18,670. The subsequent vote on the treaty itself was 49-32 in favor, *ibid.*—five votes less than the two-thirds required by the Constitution. On June 27, 1978, the treaty was approved by the Senate subject to the Church reservation. *Id.* at 19,076. U.S. and U.K. negotiators ultimately agreed upon a third protocol to the treaty, which incorporated the Church reservation on a bilateral basis and included concessions to the British on offshore drilling profits and the insurance premiums excise tax. That protocol was approved by the Senate by a vote of 98-0 (125 Cong. Rec. 17,433 (1979)) and soon thereafter was approved by the House of Commons.

The Carter Administration addressed the WWCR issue on at least one additional occasion. On March 31, 1980, Assistant Secretary of the Treasury for Tax Policy Donald C. Lubick presented before the House Ways and Means Committee the Treasury Department's views on H.R. 5076 (96th Cong., 2d Sess. (1980)), a bill that would have essentially barred the States' use of WWCR. The Assistant Secretary's statement noted that "[a]lthough the bill makes no distinction between corporate groups under United States control and those under foreign control, such a distinction may be warranted." 92-1384 J.A. 588. He explained, in particular, that "the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all." *Id.* at 589. The statement con-

cluded that "[t]he Treasury Department supports the goals of [this provision] of the bill, with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of [this part] of the bill insofar as U.S. controlled corporate groups are concerned." *Ibid.*

2. The brief amicus curiae filed by the United States in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, No. 81-349, in January 1982 was in two respects a departure from prior executive branch practice. For the first time the government's criticisms of the worldwide method were couched in constitutional terms. Second, the government's opposition to the States' use of WWCR was extended to cover the method's application to domestic corporations with foreign subsidiaries.[6] The government argued, *inter alia,* that the Illinois taxing scheme was invalid because the "unitary method impairs the otherwise uniform international custom that is the basis of the treaties between the United States and numerous foreign countries that are intended to prevent international double taxation of income." Br. 16. The brief noted that several foreign governments had protested the States' continued use of WWCR. *Ibid.* The brief did not, however, cite any statement by an executive branch official setting forth the position of the federal government regarding the States' use of WWCR.

Chicago Bridge & Iron was held over to the following Term, and the Court granted certiorari in *Container Corp.* The United States did not submit a brief in *Container Corp.*, and this Court upheld the use of WWCR as applied to a domestic corporation with foreign subsidiaries. The Court distinguished its prior decision in *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434

[6] The brief acknowledged, however, that application of WWCR to foreign-controlled corporations raised even greater concerns; accordingly, the brief cautioned that "the Court should not decide this case on any ground that would foreclose any claims that may be raised in a future case involving the imposition of the combined reporting method to a group of corporations with a foreign parent." 81-349 Amicus Br. at 19.

(1979), by noting, *inter alia,* that "in this case, unlike *Japan Line,* the Executive Branch has decided not to file an *amicus curiae* brief in opposition to the state tax." 463 U.S. at 195. It acknowledged the government's filing in *Chicago Bridge & Iron,* but asserted that "there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case." *Id.* at 195 n.33. The dissent took issue with this statement, arguing that there was "no reason to ignore [the Government's] view in one case currently pending before the Court when considering another case that raises exactly the same issue," and noting that "[t]he Solicitor General has not withdrawn his memorandum, nor has he supplemented it with anything taking a contrary position." *Id.* at 204 (Powell, J., dissenting).

This Court's decision in *Container Corp.* was issued on June 27, 1983.[7] In the wake of that decision, President Reagan established the Worldwide Unitary Taxation Working Group, a diverse group of federal and state officials and representatives of the business community. That group was "charged with producing recommendations . . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." Chairman's Report on the Worldwide Unitary Taxation Working Group at 3 (1984). The Group considered comments from a wide spectrum of interested parties, including foreign governments and foreign taxpayers.

On July 31, 1984, Secretary of the Treasury Regan, as chairman of the Worldwide Unitary Taxation Working Group, transmitted his report to the President. Members of the Working Group agree on three principles that should guide state taxation of multinationals' income: (1) a water's edge limitation on the States' application of

[7] Nine days later the Court dismissed the appeal in *Chicago Bridge & Iron* for want of a substantial federal question. *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, 463 U.S. 1220 (1983).

formula apportionment to both foreign and domestic corporations; (2) federal administrative assistance to the States in their application of the arm's length method; and (3) "[c]ompetitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." Chairman's Report at ii.

The report did not propose immediate federal action to implement these principles. Rather, Secretary Regan's cover letter noted that "[i]f states enact legislation based on the three principles agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners, and this irritant to international commercial relations will have been eliminated." Chairman's Report at iii. Secretary Regan recommended that the administration shou'd support federal legislation only if the States failed to make appreciable progress in implementing the Group's recommendations within a suitable interval. *Ibid.*

3. Subsequent progress at the state level proved inadequate, however, and on November 8, 1985, President Reagan issued a statement calling for federal legislation to impose a water's edge standard on state taxation of multinationals. 92-1839 J.A. 7. The President stated that "[s]ince states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law." *Ibid.* The President's statement also noted that "[f]urther, I am instructing the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach." *Id.* at 8.

On December 18, 1985, the Treasury Department proposed legislation that would prohibit the States' use of WWCR and provide the States with federal assistance in their application of the arm's length method. That legislative proposal was introduced in the Senate as S. 1974 (99th Cong., 1st Sess. (1985)), and in the House as H.R. 3980 (99th Cong., 1st Sess. (1985)). In a letter addressed to the Speaker of the House and President of the

Senate, Secretary of the Treasury Baker explained that "[t]he practice of a small but important minority of the states of assessing corporate income tax on a worldwide unitary basis has caused serious difficulties with the conduct by the federal government of our foreign economic policy." Letter from the Secretary of the Treasury to the President of the Senate 1 (Dec. 18, 1985) (hereafter "Baker letter"). The Secretary noted that this country's trading partners had raised numerous objections to the worldwide method and stated, "We agree with these contentions." *Ibid.* The Secretary further observed that continued use of WWCR at the state level had resulted in the adoption (though not yet in the implementation) of retaliatory legislation by the U.K., and he asserted that "[i]t has become clear that the ability of the federal government to speak with one voice in the conduct of foreign economic affairs is significantly weakened because of these state tax practices." *Ibid.*

The Secretary acknowledged that significant progress had been made after dissemination of the Working Group's recommendations, but he concluded that "[t]he failure to date to achieve voluntary compliance by all states with the principles adopted by the Working Group, and the increasing international difficulties caused by continued adherence by a few states to the worldwide unitary method, have led the Administration to conclude that restrictive legislation should now be adopted." Baker letter at 2. The Secretary also noted that the administration bill would bar the use of WWCR as to both foreign and domestic corporations. He acknowledged that "the principal foreign commerce issues raised by state worldwide unitary taxation would be resolved if states were to agree that they would not impose worldwide unitary tax on foreign controlled entities." *Ibid.* The Secretary asserted, however, that such an approach would cause other serious problems by effecting a form of discrimination between domestic and foreign businesses (in favor of the latter). *Ibid.* The Secretary also emphasized that the legislation

provided for federal assistance in the States' administration of the arm's length method. *Id.* at 2-3.

On January 30, 1986, Secretary of State Shultz wrote to the governors of the States that continued to employ WWCR. The letter stated: "I am writing to explain to you the foreign policy concerns that prompted this legislation and to urge you to act promptly to reconsider your state's use of the worldwide unitary method of taxation." 92-1384 J.A. 601. The letter noted that the States' use of WWCR had prompted diplomatic complaints from numerous countries and retaliatory legislation from the U.K., and concluded: "For these reasons I believe state worldwide unitary taxation to be inappropriate. Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the internaional arena and to manage the sensitive issue of international double taxation." *Id.* at 602-603.

On March 7, 1986, the United States filed a brief amicus curiae in *Alcan Aluminum Ltd.* v. *Franchise Tax Board*, No. 84-C-6932 (N.D. Ill.), a suit seeking injunctive relief against California's application of WWCR to foreign corporations. The government's brief argued that the California tax violated the Foreign Commerce Clause. The Shultz letter was attached as an exhibit in support of the contention that the California law had adversely affected the nation's foreign policy.[8]

On September 29, 1986, J. Roger Mentz, Assistant Secretary of the Treasury for Tax Policy, testified before a Senate subcommittee regarding the pending legislative proposal. Assistant Secretary Mentz asserted that significant progress had been made in inducing States to abandon WWCR without the passage of federal legisla-

[8] The complaint in *Alcan* was dismissed on jurisdictional grounds. The United States did not participate in the case in either the court of appeals or this Court, in which the only issue was federal jurisdiction. This Court ultimately held that Alcan's suit was barred by the Tax Injunction Act, 28 U.S.C. 1341. See *Franchise Tax Board* v. *Alcan Aluminium Ltd.*, 493 U.S. 331, 338-341 (1990).

tion, and that "the most significant progress is California." S. Hrg. 1066, 99th Cong., 2d Sess. 63 (Sept. 29, 1986). (California had amended its tax statute on September 5, 1986, to provide for a water's edge election, albeit an election contingent upon the payment of a significant fee. See note 3, *supra*.) The Assistant Secretary acknowledged that "California's legislation also has some elements in it that are inconsistent with the President's statement, and with S. 1974," but concluded, "since there has been such significant progress, that restrictive Federal legislation is not warranted at this time." *Ibid.* Instead, the Assistant Secretary recommended that "congressional action on S. 1974 should be deferred until the remaining worldwide unitary states have a full opportunity to act, California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect." *Id.* at 71-72 (92-1384 J.A. 441).

4. The federal government continued its involvement, however, in litigation challenging the constitutionality of the former California taxing scheme. On September 17, 1986, the United States filed a brief amicus curiae in the California Superior Court supporting Barclays Bank in the instant suit for refund of taxes paid in tax year 1977. In support of its claim that California's use of WWCR had undermined the federal government's conduct of foreign economic policy, the brief cited (1) the Shultz letter of January 30, 1986, (2) the retaliatory legislation enacted by the U.K. in the summer of 1985, and (3) protests received from other trading partners. The government maintained its support for Barclays throughout the state-court litigation.[9] The United States has not, how-

[9] At an earlier stage of this case, the United States expressed in this Court the view that California's application of WWCR to foreign-controlled corporate multinationals violated the Commerce Clause. 92-212 U.S. Amicus Br. at 12-13.

ever, participated as amicus curiae at any stage of Colgate's lawsuit.

SUMMARY OF ARGUMENT

1. A state taxing scheme may not constitutionally be applied to foreign commerce if it will "impair federal uniformity in an area where federal uniformity is essential, and prevent[] the Federal Government from speaking with one voice in international trade. *Container Corp.*, 463 U.S. at 193 (citation and internal quotations omitted). In applying this test to concrete cases, the question is whether the state action at issue is incompatible with federal policy as adopted and explicated by officials of the executive and legislative branches. In undertaking this inquiry, moreover, the court must look to federal policies in effect at the time the tax was levied, lest States unjustly be held liable for refunds of taxes that violated no federal policy, and were thus in no way unlawful, at the time the disputed tax liability was incurred.

2. Judged against this standard, Barclays' claim must fail. As of 1977 (the tax year in question) executive branch officials had expressed a preference for the arm's length method and had negotiated a treaty prohibiting application of WWCR to U.K.-controlled corporate taxpayers. These officials had not, however, indicated that further use by the States of WWCR would be incompatible with a standard to which the United States was committed by general agreement with its trading partners. To the contrary, executive branch officials during the treaty debate gave assurances that in the event of the treaty's approval by the Senate, States could continue to apply WWCR to corporations controlled by other (*i.e.*, non-U.K.) foreign nationals, and that their right to do so would not be bargained away except in return for concessions from our trading partners. Against this backdrop, the executive branch's negotiation of the treaty and

efforts to effect its approval by the Senate cannot accurately be viewed as manifesting a then-existing federal policy requiring uniformity among the States.

3. Colgate-Palmolive Company, a domestic corporation, seeks refunds of taxes paid from the years 1970-1973. That claim should be denied. During the years in question, no federal policy precluded the States' application of WWCR to domestic taxpayers; indeed, the U.S.-U.K. treaty was renegotiated in 1976 to make clear that it would not bar the States from applying the worldwide method to domestic corporations with British subsidiaries. Moreover, although the executive branch in 1982 and thereafter has opposed the application of WWCR to domestic taxpayers, that opposition has not been based on foreign relations concerns. California's application of WWCR to Colgate should be upheld even if Barclays prevails in its legal challenge, since Colgate's "equal treatment" argument is without merit.

4. Finally, if this Court concludes that the taxes at issue in these cases were unlawfully collected, it should make clear that in the unusual circumstances presented here, California is under no federal constitutional obligation to provide refunds. The taxes here were not inherently beyond California's power to levy; petitioners were not immune from income taxation in California, and they did not suffer unlawful discrimination vis-a-vis some other class of taxpayers. Rather, the gravamen of petitioners' claim is that California's use of WWCR during prior years impaired the federal government's ability to conduct foreign commercial policy. California's payment of money to the petitioners will not, of course, undo any disruption of federal government policy that may have already occurred, and in light of the recent modification of California's tax scheme, the executive branch has concluded that the provision of refunds for past years is unnecessary to protect the federal government's ability to speak with one voice in international trade.

ARGUMENT

1. This Court's opinion in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977), sets forth the factors governing dormant Commerce Clause challenges to the States' regulation of domestic commerce. This Court has made clear, however, that "an inquiry more elaborate than that mandated by *Complete Auto* is necessary when a State seeks to tax the instrumentalities of foreign, rather than of interstate, commerce." *Japan Line*, 441 U.S. at 451. In particular, a state taxing scheme may not constitutionally be applied to foreign commerce if it will "impair federal uniformity in an area where federal uniformity is essential, and prevent[] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citation and internal quotations omitted).[10]

This more searching scrutiny is appropriate, in part, because "[f]oreign commerce is preeminently a matter of national concern." *Japan Line*, 441 U.S. at 448. In addition, however, this Court's approach reflects a recognition that in the sphere of foreign relations, federal officials are particularly likely to act by methods lacking legal formalities. That is, in the foreign sphere, federal policy is especially likely to take the form of informal agreements, understandings, long-term strategies, etc., that have not been codified in a statute or treaty. Cf. *United States* v. *Curtiss-Wright Export Corp.*, 299 U.S. 304, 320 (1936) (noting that President's power in the

[10] As an initial matter, the United States notes its disagreement with the California Supreme Court's reliance on this Court's decision in *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. 1 (1986). The most extensive congressional consideration of the States' use of WWCR—the 1977-1978 debate over ratification of the U.S.-U.K. Tax Convention—produced a substantial majority within the Senate in favor of Article 9(4). The Senate's final action on the treaty, in our view, should not be seen as affirmative permission for States to use the worldwide method; indeed, much of this Court's analysis in *Container Corp.* would have been unnecessary if Congress had already spoken.

field of international relations "does not require as a basis for its exercise an act of Congress").[11] The President's ability to deal with foreign governments in an effective manner would be seriously undermined if the accords he reaches could not be binding upon the States. Inquiry under the Commerce Clause is thus particularly searching where *foreign* commerce is concerned, because in this context it is particularly likely that a state law will disrupt federal *policy* even where it is preempted by no federal *law*.[12]

The difficulty, of course, lies in identifying those areas "where federal uniformity is essential." In the present dispute, it is quite clear that federal law has long embodied a *preference* for the arm's length method, in the sense that this method is used in computing the federal income tax liability of multinational corporations. This Court has recognized, however, that "[c]oncurrent federal

[11] Supersedure of state law by federal policies uncodified in any statute, treaty, or regulation is unusual, but it is not confined to the Foreign Commerce Clause. In *Boyle* v. *United Technologies Corp.*, 487 U.S. 500 (1988), for example, this Court held that a state-law tort suit alleging negligent design could not lie against a contractor that had furnished military equipment to the government in compliance with precise contractual specifications. In areas of "uniquely federal interest," the Court recognized, state law would be displaced where "a significant conflict exists between an identifiable federal policy or interest and the operation of state law." 487 U.S. at 507 (brackets and internal quotations omitted).

[12] It is entirely clear, of course, that a federal statute or treaty prohibiting the States' use of WWCR would be a permissible exercise of federal power. In a certain sense it is thus at least potentially misleading to say that a State's method of taxation can ever "prevent" the federal government from speaking with one voice. See *Itel Containers Int'l Corp.* v. *Huddleston*, 113 S. Ct. 1095, 1108 (1993) (Scalia, J., concurring in part and concurring in the judgment). The danger, more precisely stated, is that a State's taxing scheme may prevent the federal government from implementing its policies *by methods other than statutes or treaties*. That danger is particularly acute in the realm of foreign relations, where important international understandings may for various reasons be less formalized.

and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 448 (1980). Nor is it dispositive that the federal government has not embraced the WWCR method under its numerous bilateral agreements. This Court must look in addition to other factors to determine whether divergence between state and federal methods of taxation is tolerable in a particular sphere. We believe the Court's inquiry should be guided by the following principles:

a. This Court in *Container* observed that "[t]he most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." 463 U.S. at 194. Accord, *Japan Line*, 441 U.S. at 450 (foreign "retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing state, so that the Nation as a whole would suffer"). The prospect of foreign retaliation serves to explain why a state tax may raise issues of national concern even when it is not imposed upon residents of other States. Threats of retaliation by foreign governments, however, cannot be sufficient *in themselves* to render a state tax invalid. Such a legal rule would in essence give foreign governments a "heckler's veto" over state taxing authorities. The rule would, moreover, encroach upon executive power by depriving the President of the authority to resist foreign demands when he considers resistance to be appropriate. Thus, in applying the "one voice" standard, foreign reaction cannot be dispositive in determining the propriety of a contested state tax.

The corollary to this proposition is that the political branches must be given primary responsibility for developing and articulating the foreign policy of the United States. As the Court observed in *Container Corp.*, "[t]his

Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." 463 U.S. at 194. The second of these concerns is of particular importance. The factual question whether a particular state tax will precipitate foreign complaints, although far more expertly addressed by the political branches, is not wholly insusceptible of resolution through judicial proceedings. Questions concerning the federal government's proper response to such complaints, however, raise issues of foreign *policy* falling entirely outside the judicial ken.[13]

Thus, in applying the "one voice" test, the crucial question is whether the state action at issue is incompatible with federal policy as explicated by officials of the political branches.[14] We do not contend that executive branch personnel have the power to issue binding pronouncements declaring state taxing practices unconstitutional. In determining whether a state tax impairs the federal government's ability to speak with one voice, however, the Court must ascertain the contours of federal policies not codified in any statute or treaty; and in that process the statements of executive branch officials are entitled to substantial evidentiary weight.

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[13] "[M]atters relating 'to the conduct of foreign relations . . . are so exclusively entrusted to the political branches of government as to be largely immune from judicial inquiry or interference.'" *Haig* v. *Agee*, 453 U.S. 280, 292 (1981) (quoting *Harisiades* v. *Shaughnessy*, 342 U.S. 580, 589 (1952)). Cf. *Japan Whaling Ass'n* v. *American Cetacean Society*, 478 U.S. 221, 230 (1986).

[14] Similarly in *Boyle*, this Court did not attempt to determine by dint of its own expertise which state-law design requirements, if applied to military contractors, would impinge unduly upon the implementation of federal policy. Rather, the Court asked whether particular state-law requirements conflicted with contractual design specifications actually negotiated by federal procurement officials. See 487 U.S. at 509, 512.

The danger of improper encroachment on the President's conduct of foreign affairs, as noted above, is not limited to the situation where a State's method of taxation conflicts with an international understanding agreed to by the President or otherwise undermines the nation's international trade policies. Executive power is also improperly diminished when a court strikes down a state law on the basis of a foreign complaint that the President has determined to resist. Thus, in the absence of a dispositive statute or treaty, the courts must respect the judgments of the President regarding matters of foreign policy both where the President has determined that state compliance with an international norm is essential and where he has determined that foreign governments should not be allowed to dictate the practices of the States. The executive branch must be free in addition to adopt a middle ground: to acknowledge the validity of foreign concerns, and to attempt to persuade state officials to respond thereto, without insisting upon the States' immediate conformity with the federal norm. The courts therefore should not lightly infer a Foreign Commerce Clause violation from the mere fact that executive branch officials have attempted to persuade state authorities to alter their policies. Such an approach not only risks undue impairment of legitimate state prerogatives; it may also reduce presidential power by diminishing the executive's ability to employ "jawboning" and informal negotiation without invoking the specter of a constitutional confrontation.

b. In the past the Court has responded to these concerns partly by attaching special significance to the government's decision whether to file a brief amicus curiae in litigation brought by private taxpayers. See, *e.g.*, *Container Corp.*, 463 U.S. at 195-196; *Itel Containers*, 113 S. Ct. at 1105. The Court has thus treated amicus participation by the United States as significant evidence of the state tax's likely effect on the federal government's ability to conduct foreign policy. This pronounced reluctance to invalidate state laws as violative of the "one voice" princi-

ple in the absence of an amicus submission by the federal government has helped to ensure both that legitimate state taxing choices are not unnecessarily precluded and that the Court does not unwittingly subvert the President's conduct of foreign economic policy.

c. There are, however, difficulties—both theoretical and practical—with this approach. It is highly unusual that a legal brief should be given (in effect) evidentiary weight in the very case in which it is filed. It is unusual as well to permit the introduction of evidence at the appellate stage of legal proceedings. The most serious problem, however, arises in suits (such as this one) seeking refunds of taxes collected during prior years.[15] A brief filed by the government in 1994 provides a clear indication of current executive branch policy. It is not entitled to the same weight, however, in determining what policy was in place in 1977. Inordinate reliance on the government's current policy can therefore present the risk that States will be held liable for refunds of taxes that violated no federal policy, and were thus in no way unlawful, at the time of their collection.

Our prior briefs in this case were flawed, we now believe, not in their discussion of the generally applicable legal principles, but because they failed adequately to consider the state tax's consistency with federal policy during the particular tax years in question. These briefs cited no executive branch pronouncements antedating President Regan's Statement of November 8, 1985. In contending that the state tax was contrary to the federal government's foreign commercial policy, we argued in the California Supreme Court that "[t]he adoption by the Federal Executive of this policy is evidenced by the letter of January 30, 1986, from the Secretary of State for the United States to the Governor of California." 92-1384 Pet. App. H-31. Similarly, our brief amicus curiae in

[15] Because of the Tax Injunction Act, 28 U.S.C. 1341, a Commerce Clause challenge to a State's taxing scheme is far more likely to reach this Court in the context of a suit for refund than in any other posture. See *Alcan Aluminium*, 493 U.S. at 338-341.

this Court at a prior stage of this case asserted that the California tax "prevents the United States from speaking with one voice on this sensitive and important matter" (92-212 U.S. Amicus Br. at 12-13), but did not examine the contours of federal policy as it existed in 1977—the tax year at issue.

A focus on current federal policy would be appropriate in a suit for declaratory or injunctive relief against *continued* imposition of a contested state tax. We now believe, however, that proper analysis of Barclays' *refund* claim requires a focus on federal policy during the tax year in question. Throughout this litigation the government has argued that a state tax violates the Foreign Commerce Clause if it is incompatible with an international standard to which the United States has committed itself by general agreement with its trading partners. We adhere to that view, which was accepted by this Court in *Japan Line*. To establish a constitutional violation, however, petitioner must show that the incompatibility existed prior to the accrual of the disputed tax liability.

Recent developments in related areas of the law make a precise focus on the contested tax year particularly important. Just last Term, this Court made clear that its decisions in civil cases must be given retroactive effect. *Harper* v. *Virginia Dep't of Taxation*, 113 S. Ct. 2510, 2517 (1993). *Harper*, together with *McKesson Corp.* v. *Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31, 39-41 (1990), also established that when a state tax is determined to have been unlawfully collected, the Constitution requires meaningful retrospective relief, ordinarily in the form of refunds. *Harper*, 113 S. Ct. at 2519-2520. These cases underscore the importance of a rigorous approach to the question whether a State tax was fatally inconsistent with federal foreign policy at the time the disputed tax liability accrued.

d. For the foregoing reasons, the Court's inquiry in the present case should focus on the federal government's

foreign economic policy as it existed in 1977.[16] In our view, no federal policy precluding the States' application of WWCR existed at that time.[17]

As of 1977, federal officials had not indicated that further use by the States of WWCR would be incompatible with a standard to which the United States was committed by general agreement with its trading partners. Rather, the sole executive branch initiative to constrain the States' use of the worldwide method was its negotiation of Article 9(4) of the United States-United Kingdom Tax Convention. In defending that provision, Treasury Department officials asserted that the arm's length approach was the more accurate method of distinguishing domestic from foreign income. These officials also emphasized, however, that Article 9(4) should be judged not in isolation, but as part of a larger agreement offering substantial advantages to the United States. Perhaps most significantly, executive branch officials gave assurances that in the event of the treaty's approval by the Senate, States could continue to apply WWCR to corporations controlled by other (*i.e.*, non-U.K.) foreign

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[16] This case does not present the question whether California's taxing scheme was fatally inconsistent with federal policy during any year subsequent to 1977, and the United States accordingly does not address that question, which, in our view, should ultimately be resolved in accordance with the legal standards set forth in this brief.

[17] We do not suggest, of course, that this case is governed by Commerce Clause *jurisprudence* as it existed in 1977. *Harper* makes clear that principles of law announced by this Court after 1977 apply to Barclays' claim for refunds. See 113 S. Ct. at 2517. This Court's task, however, is to apply these legal principles to the *facts* —including, where pertinent, the contours of executive branch policy—as they existed when the disputed tax liability accrued.

Similarly, in applying the "government contractor" defense recognized in *Boyle*, a court's focus must be on government procurement specifications as they existed when the product at issue was manufactured. See 487 U.S. at 512. A contractor that complied with existing specifications could not be held liable on a theory of improper design simply because federal procurement policy had changed by the time the suit was finally resolved.

nationals, and that their right to do so would not be bargained away except in return for concessions from our trading partners.

Against this backdrop, executive branch actions prior to and during the tax year in question cannot accurately be viewed as manifestations of a then-existing federal policy requiring uniformity among the States. As of 1977, the executive branch had expressed a preference for the arm's length method and had proposed the adoption of a legal bar on the States' application of WWCR to *British*-controlled corporations. Surrounding events make quite clear, however, that the United States had not at that time acceded to any general international understanding regarding the impropriety of the worldwide method. To the contrary, during the 1977-1978 debates, executive branch officials expressly affirmed that States would remain free to apply WWCR to other foreign-controlled corporations even if the treaty were approved. California's application of WWCR to foreign-controlled corporations in 1977 therefore did not impermissibly intrude upon the federal government's conduct of foreign relations.[18]

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[18] Barclays also contends (92-1384 Pet. Br. 32-34) that California's application of WWCR to foreign-controlled multinationals creates a constitutionally impermissible risk of international double taxation. This Court held in *Container* that the risk of double taxation, though real, was not sufficiently grave to warrant invalidation of the WWCR method as applied to domestic corporations. 463 U.S. at 189-193. This Court reserved the question whether the tax could validly be applied to a foreign corporation, *id.* at 189 n.26, and noted that "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 189 (quoting *Japan Line*, 441 U.S. at 456).

While the Court has sometimes appeared to treat double taxation and interference with federal foreign policy as separate dangers, see *Container Corp.*, 463 U.S. at 185-186, in fact in this context they are fundamentally intertwined. A level of double taxation that is constitutionally acceptable with respect to a domestic corporation could be deemed unacceptable with respect to a foreign taxpayer only on the ground that its application to foreign entities might trigger complaints or retaliation from other governments and hence disrupt our foreign commercial policy. Cf. *Japan Line*, 441 U.S. at 450-451. Since (as we demonstrate above) California's aplication of WWCR to foreign-controlled corporations in 1977 did not impermissibly intrude upon the federal government's conduct of foreign relations, Barclays' double taxation argument correspondingly fails.

3. Colgate-Palmolive Company, the petitioner in No. 92-1839, seeks refunds of taxes paid for the years 1970-1973. Colgate, a United States corporation, first argues that application of WWCR to domestic multinational corporations is impermissible because it impairs the federal government's ability to conduct foreign relations. Colgate contends that *Container Corp.* is not controlling because "[t]he missing evidence of the Executive Branch's opposition to worldwide combined reporting, which was crucial to the Court's decision in *Container*, has been supplied" (92-1839 Pet. Br. at 34) by subsequent executive branch pronouncements. In the alternative, Colgate contends that, even if application of WWCR to domestic corporations does not itself impair the conduct of foreign policy, a holding in Barclays' favor would require that the tax be invalidated as to domestic corporations as well, on the ground that application of different rules to domestic and foreign corporations "would seriously undermine the level playing field for different forms of protected commerce." *Id.* at 46. Colgate's claim should be rejected.

a. It is entirely clear that during the tax years in question there existed no federal policy against the States' application of WWCR to domestic corporations. Indeed, in 1976 the U.S.-U.K. Tax Convention was renegotiated in order to make clear that the treaty would *not* bar the States from applying WWCR to domestic corporations with British subsidiaries. As late as 1980, when the Treasury Department first expressed support for federal legislation barring the States from applying WWCR to foreign corporations, the Department noted that "[a]lthough the bill makes no distinction between corporate groups under

United States control and those under foreign control, such a distinction may be warranted." 92-1384 J.A. 588.[19] Application of WWCR to domestic corporations during the period at issue in this case therefore cannot be said to have "prevent[ed] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citations and internal quotations omitted).[20]

b. As we have noted, see pp. 8, 11-12, the executive branch since 1982 has opposed the States' application of WWCR to domestic as well as foreign corporations. The executive has not asserted, however, that application of WWCR to domestic taxpayers interferes with the federal government's conduct of foreign relations. In submitting the Treasury Department's 1985 legislative proposal to Congress, Secretary Baker acknowledged that "the principal foreign commerce issues raised by state worldwide unitary taxation would be resolved if states were to agree that they would not impose worldwide unitary tax on foreign controlled entities." Baker letter at 2. The Secretary defended the scope of the proposed legislation (which would have barred the application of WWCR to both domestic and foreign taxpayers) not on foreign policy grounds, but as a means of preserving "competitive balance for domestic multinationals, foreign multinationals and purely domestic businesses in any resolution of the

[19] The Assistant Secretary of the Treasury for Tax Policy explained, in particular, that "the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all." 92-1384 J.A. 589.

[20] Colgate also argues that California's application of the unitary method violates a "clear federal directive" within the meaning of this Court's decision in *Container Corp.*, 92-1839 Pet. Br. at 34-36; see 463 U.S. at 194. This Court's analysis of the "clear federal directive" test in *Container Corp.* focused exclusively on pertinent *congressional* enactments, see *id.* at 196-197, and did not discuss executive branch pronouncements. In any event, Colgate has identified no pertinent executive branch pronouncement issued prior to or during 1970-1973, the tax years in question.

unitary issue." *Ibid.* Since that time the executive branch has continued to express the view that "[a]s a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations." 92-1839 J.A 35. The executive has not, however, asserted that application of WWCR to domestic corporations will impair the government's conduct of foreign relations, nor has the government participated in support of Colgate's constitutional claim at any stage of this litigation. Colgate therefore has wholly failed to show that California's application of the worldwide method to domestic taxpayers has "prevent[ed] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citations and internal quotations omitted).

c. Finally, we believe that California's application of WWCR to Colgate should be upheld even if Barclays prevails in its legal challenge, since Colgate's "equal treatment" argument is without merit. The executive branch, we acknowledge, has previously expressed the view that divergent treatment of foreign and domestic taxpayers is undesirable as a matter of tax policy. Colgate cites no authority, however, holding that discrimination in favor of foreign taxpayers raises *constitutional* concerns under the Foreign Commerce Clause. The difference in treatment would be rationally justified by a finding that application of WWCR to foreign corporations has impaired the federal government's conduct of foreign economic policy and engendered frequent complaints by foreign nations, while application of this accounting method to domestic taxpayers has had neither of these consequences.[21]

[21] Taken to its logical conclusion, Colgate's argument implies that whenever a domestic taxpayer raises a Commerce Clause challenge to a state tax law, the reviewing court must determine whether that law could permissibly be applied to a foreign taxpayer, and must strike it down on "equal treatment" grounds if its application in the foreign context would be improper. That cannot be the law. Indeed, the whole point of *Japan Line* is that taxing practices that

4. For the foregoing reasons, we believe that the taxes at issue in these cases violated no federal policy and therefore were not unlawfully collected. If the Court holds otherwise, however, we believe it should make clear that in the unusual circumstances presented here—specifically, the recent modification of the State's taxing scheme—California is under no federal constitutional obligation to provide refunds.[22]

When a state tax is determined to have been unlawfully collected, "the Due Process Clause of the Fourteenth Amendment obligates the State to provide meaningful backward-looking relief to rectify any unconstitutional deprivation." *McKesson*, 496 U.S. at 31 (footnotes omitted). Accord *Harper*, 113 S. Ct. at 2519. Under some circumstances—as, for example, where the tax "was beyond the State's power to impose," *McKesson*, 496 U.S. at 39, or where "the taxpayers were absolutely immune from the tax," *ibid.*—the required remedy is a refund of taxes previously collected. In other situations, however,

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are permissible with respect to domestic commerce are sometimes unlawful as applied to foreign commerce and/or foreign taxpayers.

[22] The supplemental brief filed by Barclays at the petition stage asserts that the United States, in its brief amicus curiae filed in October 1993, "completely omits any reference to the other six states that use worldwide combined reporting." 92-1384 Supp. Pet. Br. at 7. Although this statement was unsupported by statutory citations, petitioner's counsel of record has indicated that Alaska, Idaho, Montana, North Dakota, Tennessee, and Utah are the six States at issue. However, none of these States uses a WWCR system like the California system at issue here. In Utah, for example, WWCR is entirely elective for taxpayers. Utah Code Ann. §§ 59-7-304(3) (repealed effective 1/1/94) and 59-7-403 (effective 1/1/94) (1992 & Supp. 1993). Idaho, Montana, and North Dakota allow taxpayers to elect "water's edge" treatment in lieu of WWCR. Idaho Code 63-3027B (1989 & Supp. 1993); Montana Code Ann. §§ 15-31-322 to 15-31-326 (1993); North Dakota Century Code ch. 57-38.4-02 (1993). Alaska and Tennessee require WWCR only for certain sectors (oil and gas and financial institutions, respectively), Alaska Stat. § 43.20.073 (1990 & Supp. 1992) and Tennessee Code Ann. § 67-4-812(c)(1)(B) (1989 & Supp. 1993), and we are not aware of any objections expressed by the affected taxpayers.

the State "retains flexibility" to devise alternative adjustments that will cure the illegality, even if those adjustments do not involve the payment of money to the plaintiff taxpayer. *Ibid.*; *Harper*, 113 S. Ct. at 2519. Thus, where a state tax is found to have discriminated impermissibly against interstate commerce, "the State may assess and collect back taxes from [the taxpayer's] competitors who benefited from the rate reductions during the contested tax period, calibrating the retroactive assessment to create in hindsight a nondiscriminatory scheme." *McKesson*, 496 U.S. at 40.

In the present case, the tax at issue was not beyond the State's power to impose; it utilized a constitutionally fair method of apportioning income under this Court's decision in *Container Corp.* The petitioners were not immune from income taxation in California. Nor have petitioners suffered unlawful discrimination vis-a-vis some other class of taxpayers. Rather, the gravamen of petitioners' claim is that California's use of WWCR during prior years impaired the federal government's ability to conduct foreign commercial policy.

California's payment of money to the petitioners will not, of course, undo any disruption of federal government policy that may have already occurred. This is consequently a rare situation in which the provision of "meaningful backward-looking relief" is infeasible because the alleged constitutional injury—the impairment of the federal government's ability to conduct the nation's foreign policy—simply is not remediable by judicial order. A monetary remedy might nonetheless be appropriate if it appeared likely that the State's failure to provide refunds would itself become a subject of international contention or inspire reprisals from foreign governments. In light of the recent modification of California's tax scheme, however, the executive branch has concluded that the provision of refunds for past years is unnecessary to protect the federal government's present or future ability to speak in the future with one voice in international trade—*i.e.*, that California's prospective change suffices to eliminate

the basis for invalidating the taxes at issue. Indeed, the United Kingdom has deferred the implementation of retaliatory measures and has indicated that it will retaliate "only if it is found that the [1993 California] legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle." 92-1384 Supp. Pet. Br. App. A-36. In these unusual circumstances, we believe that the Constitution imposes upon California no duty to provide a retrospective monetary remedy to corporate entities whose taxes were previously calculated on the basis of the worldwide method.

CONCLUSION

With respect to the questions discussed in this brief, the judgments of the court of appeal should be affirmed.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

MALCOLM L. STEWART
Assistant to the Solicitor General

JANUARY 1994

☆ U. S. GOVERNMENT PRINTING OFFICE: 1994 301187 66089

(1)

Supreme Court, U.S.
FILED
DEC 15 1993
OFFICE OF THE CLERK

No. 92-1839

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

COLGATE-PALMOLIVE CO.,

Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,

Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California for the Third Appellate District

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BRIEF FOR NATIONAL FOREIGN TRADE COUNCIL, INC. AND EMERGENCY COMMITTEE FOR AMERICAN TRADE AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

PHILIP D. MORRISON
(Counsel of Record)
MARY C. BENNETT
KIMBERLY J. TAN
BAKER & MCKENZIE
815 Connecticut Avenue, N.W.
Washington, D.C. 20006
(202) 452-7000

Attorneys for National Foreign Trade Council, Inc. and Emergency Committee for American Trade

Of Counsel:

J. PAT POWERS
BAKER & MCKENZIE
660 Hansen Way
Palo Alto, CA 94304
(415) 856-2400

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

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BRIEF FOR NATIONAL FOREIGN TRADE COUNCIL, INC. AND EMERGENCY COMMITTEE FOR AMERICAN TRADE AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICI CURIAE*

The National Foreign Trade Council, Inc. (NFTC), established in 1914, consists of approximately 500 U.S.-based manufacturing companies, financial institutions, and other firms with substantial international operations and interests. Its members account for more than 60 percent of all U.S. non-agricultural exports and more than 60 percent of all U.S. private foreign investment. The NFTC's purpose is to develop policies designed to expand exports, protect U.S. foreign investment, enhance the competitiveness of U.S. industry, and promote and maintain a fair and equitable international trading system.

The Emergency Committee for American Trade (ECAT) is an organization of the leaders of approximately 60 large U.S. firms with extensive international business operations. Their annual worldwide sales total well over $1 trillion, and they employ more than five million workers. ECAT's mission is the advocacy of open international economic policies that will expand international trade and investment.

The members of the NFTC and ECAT are concerned that California's use of a "world-wide combined reporting/unitary" (WWCR/Unitary) method for determining corporate income subject to tax in California impairs U.S. foreign economic relations, has incited destructive retaliatory measures by foreign governments, and thereby endangers U.S. business and the U.S. economy. Several of the members of the NFTC and ECAT have been beneficiaries of the competent authority process under various U.S. bilateral tax treaties described below. This process has allowed these members to obtain complete relief from double taxation threatened when both the United States and a foreign jurisdiction initially proposed to tax the same dollar of income. It also has provided complete relief from double taxation between states and foreign jurisdictions in those states which use a "water's edge/unitary" or "arm's length/separate accounting" (AL/SA) method, allowing them to "piggyback" off adjustments to Federal tax. Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

STATEMENT

This case challenges the constitutionality of California's use of WWCR/Unitary for determining the taxable income of a multinational group of corporations owned by a U.S. parent. CAL. REV. & TAX. CODE § 25101 *et. seq.* (West 1992 & Supp. 1993). WWCR/Unitary is a variant of the unitary/formulary apportionment method used by most states for apportioning corporate income among the several states for income tax purposes. All such methods use a formula for apportioning income, typically a three-factor formula involving property, payroll, and sales. Each method determines the income to be apportioned on a "unitary business" basis; that is, the income to be

apportioned is that which is earned in a single business that may cross jurisdictional and separate entity lines.

WWCR/Unitary determines and apportions the income from the unitary business throughout the entire world. Thus, it combines (for apportionment) income of a group of affiliated corporations, including foreign corporations with no income-producing activities in the United States. The "water's edge/unitary" method combines (for apportionment) income only of entities engaged in income-producing activities in the United States; it does not combine income of foreign affiliates that do not have such activities.

The determination of income attributable to entities doing business in the United States under the *water's edge*/unitary approach is done on an AL/SA basis. AL/SA treats U.S. and foreign corporations, although related, as separate accounting entities, dealing at "arm's length" with each other. Where it can be shown that transactions between related foreign and U.S. entities are not at arm's length, *i.e.*, they differ from comparable transactions between unrelated parties, the tax authorities that use AL/SA adjust the income of the domestic entities to reflect that which they would have earned had they dealt at arm's length. Virtually every foreign taxing jurisdiction uses the AL/SA method of determining the taxable income of corporations doing business in that jurisdiction.[1]

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[1] The trial court below in this case stated that

> The unitary method of taxation is not widely used. In international circles it is not used at all in the taxing of multinational corporations. The water's edge method is now used.

Pet. App. F at 88a. (References to the Appendix to the Petition for *Certiorari* in this case are denominated "Pet. App." followed by a letter assigned to each item and a page reference.)

The California Supreme Court stated in the companion case, "The trial court found as a matter of fact that the AL/SA method was the 'international standard of accounting' and that '[n]o other system is used internationally.'" *Barclays* Pet. App. at C-8 n.6. (References to the Appendix to the Petition for

Petitioner is the U.S. parent corporation of a multinational group of corporations including foreign corporations with no activities in California. In the years at issue, California used WWCR/Unitary to include the income of those foreign corporations in its state income base for apportionment. This action has resulted in California's taxing the same dollars of income also taxed by foreign jurisdictions.[2] This brief supports Petitioner's contention that California's action is unconstitutional under the Commerce Clause.[3] The Court of Appeal of the State of California for the Third Appellate District disagreed with Petitioner.

SUMMARY OF ARGUMENT

I.

To validate a state tax that otherwise interferes with foreign commerce, the Federal government must manifest affirmative and unambiguous approval. *Wyoming v. Oklahoma*, 112 S. Ct. 789 (1992); *South Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984). In this case, there has been no such approval. Congress's rejection of a provision of the U.S.-U.K. Tax Treaty[4] which would have prevented California's use of WWCR/Unitary is distinctly different from the Federal approval of the international convention at issue in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986). In *Wardair*, because the

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Certiorari in the companion case, *Barclays Bank PLC v. Franchise Tax Board*, No. 92-1384, are denominated "*Barclays* Pet. App." followed by a letter assigned to each item and a page reference.)

[2] California no longer mandates the use of WWCR/Unitary. It now permits a taxpayer to elect to use the water's edge/unitary method, computing apportionable income in the United States on the AL/SA basis. CAL. REV. & TAX. CODE § 25110 (West 1992 & Supp. 1993).

[3] U.S. CONST. art. I, § 8, cl. 3.

[4] Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5670 [hereinafter U.S.-U.K. Tax Treaty].

convention approved applied to 157 countries and, therefore, virtually all foreign commerce involving aviation in Florida, Congress and the Executive had essentially legislated a restriction on certain state taxes (and implicit approval of others) with respect to virtually *all* foreign commerce these taxes might touch. In the case of the rejected provision of the U.S.-U.K. Tax Treaty, on the other hand, the Executive and Congress could deal with foreign commerce with only *one* country. Indeed, the rejection was based upon the fact that broad legislation, applicable to virtually all foreign commerce, was a better route to address the problems presented by WWCR/Unitary.

II.

Because the rest of the world uses AL/SA for computing the taxable income of corporations, California's use of WWCR/Unitary in the years at issue to compute either U.S.-parent group or foreign-parent group unitary income presents a substantial risk of double taxation -- the taxation of the same dollar of income both by California and by foreign jurisdictions -- that burdens foreign commerce. California's use of WWCR/Unitary, viewed against the universal use of AL/SA by foreign jurisdictions, creates a much greater risk of international double taxation than reasonably available alternatives, such as AL/SA. For example, by using AL/SA to determine apportionable income, California could have "piggybacked", like most other states, on the results of Federal-level negotiations under a system of tax treaties that eliminate double taxation in the vast majority of cases. (California does precisely this today.) Because California could have eliminated the significant risk of double taxation presented by its use of WWCR/Unitary had it used AL/SA in the years at issue, such use violates the first of the two additional[5] Commerce Clause tests set forth in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) and, therefore, is unconstitutional under the Commerce Clause.

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[5] The *Japan Line* case introduced two tests in addition to the four tests applicable to purely interstate commerce, as outlined in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

III.

The Federal government has adopted a uniform policy favoring AL/SA, as shown by the fact that both U.S. domestic law and all U.S. tax treaties guarantee U.S. corporations the right to compute their Federal taxable income using AL/SA. California's use of WWCR/Unitary for both U.S.-parent and foreign-parent multinationals impairs that uniform Federal policy, to the serious detriment of the national interest. It has engendered concrete actions toward retaliation by numerous foreign governments. It also substantially undermines the U.S. government's efforts to ensure that neither U.S.-parent multinationals' investments abroad nor foreign-parent multinationals' investments in the United States are competitively disadvantaged through double taxation. For these reasons, it violates the second *Japan Line* test.

ARGUMENT

I. CALIFORNIA'S USE OF WWCR/UNITARY MUST NOT VIOLATE EITHER OF *JAPAN LINE*'S TWO ADDITIONAL FOREIGN COMMERCE CLAUSE TESTS SINCE THERE HAS BEEN NO UNAMBIGUOUS, AFFIRMATIVE FEDERAL APPROVAL OF THAT USE.

A. The Federal Power to Regulate Foreign Commerce Is Supreme.

Subject to explicit constitutional restraints, the power of Congress to grant protection to interstate or foreign commerce against state regulation or taxation or to withhold such protection is complete. The determination of policy made by Congress must prevail. *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451, 456 (1962). Congress may discriminate against interstate or foreign commerce and in favor of local trade or it may prohibit such discrimination. *Prudential Insurance Company v. Benjamin*, 328 U.S. 408, 434 (1946). In so doing, Congress may either act alone or it may act in concert with the states by conferring upon the states an ability to restrict the flow of interstate commerce that they would not otherwise enjoy. *Id.* In

either case, the ordinary negative implications of the Commerce Clause as regards a state's power to regulate commerce are irrelevant. *Id.*

B. The Exercise of the Supreme Federal Power to Regulate Foreign Commerce Cannot Be Inferred; It Must Be Unambiguously and Affirmatively Exercised By Constitutional Means.

Because Congress's power over interstate and foreign commerce is supreme, its exercise cannot be lightly inferred. This is particularly true where, as in this case, the state tax which burdens foreign commerce would, if upheld, trigger retaliation by foreign governments against numerous U.S.-based multinational corporations[6] and interfere with a network of bilateral tax treaties.[7] In such a case, there must be an unambiguous, affirmative expression of Congressional approval.

> Congress must manifest its unambiguous intent before a Federal statute will be read to permit or approve ... a violation of the Commerce Clause....

Wyoming v. Oklahoma, 112 S. Ct. 789, 802 (1992).

> [F]or a state regulation to be removed from the reach of the dormant Commerce Clause, Congressional intent must be unmistakably clear. The requirement that Congress affirmatively contemplate otherwise invalid state legislation is mandated by the policies underlying dormant Commerce Clause doctrine.
>
> * * *
>
> The need for affirmative approval is heightened by the fact that [a state's] policy has substantial ramifications beyond the

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[6] U.K. Finance Act, 1985, ch. 54, at 52-54, excerpt from exhibit 35 of trial court record in companion case designated for inclusion in Joint Appendix; *see Barclays* Pet. App. at A-49, ¶ 35.

[7] *See, e.g.*, U.S.-U.K. Tax Treaty, *supra* note 4, art. 9.

> Nation's borders. The need for a consistent and coherent foreign policy enhances the necessity that Congressional authorization not be lightly implied.

South-Central Timber Development, Inc. v. Wunnicke, 467 U.S. 82, 91-92 & n.7 (1984).[8]

This Court's decision in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), despite the conclusion of the court below,[9] does not alter this requirement of an unambiguous and affirmative exercise of the foreign commerce power. Indeed, the Court in *Wardair* found an unambiguous, affirmative exercise of the Federal power to approve a state tax in an international convention[10] to which the United States and 156 other nations were parties:

> Article 24(a) of the Chicago Convention by its terms precludes the imposition of local taxes on fuel only when the fuel is "on board an aircraft ... on arrival ... and retained on board on leaving" a contracting party; it does not prohibit taxation of fuel purchased in that country. 61 Stat. 1186.

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[8] In manifesting its affirmative and unambiguous intent to empower a state to burden foreign commerce, Congress must, of course, act through constitutional means. The constitutional means available to Congress to express its affirmative and unambiguous approval include the enactment of a bill (which, pursuant to U.S. CONST. art. I, § 7, can be vetoed by the Executive in which case a two-thirds vote of both Houses of Congress is required for the bill to become law) or, under U.S. CONST. art. II, the giving of consent (by two-thirds of the Senators present) to a treaty made by the Executive. In either case, of course, the Executive has a major role to play in either initiating or concurring in the affirmative, unambiguous, Congressional approval. For this reason alone, the 20 bills concerning WWCR/Unitary introduced in Congress over the past 20 years but never enacted are irrelevant to this analysis.

[9] Pet. App. B at 16a to 18a.

[10] Convention on International Civil Aviation, *opened for signature* Dec. 7, 1944, 61 Stat. 1180, 1186, 3 Bevans 944, 950 [hereinafter Chicago Convention].

477 U.S. at 10. The Executive, in negotiating the Chicago Convention, and Congress, in ratifying it, had, therefore, (1) specifically addressed the sort of tax at issue in *Wardair*, and (2) specifically prohibited the imposition of this sort of tax at issue in certain circumstances, but (3) not prohibited its imposition in the circumstances presented in the case.

Most importantly, Congress and the Executive did this with respect to an international convention that applied to 157 countries. There was no material foreign commerce left out of this action since virtually all international airlines which might possibly purchase fuel in Florida were covered. This is hardly ratification of a state tax through "governmental silence;"[11] it is, instead, an unambiguous, affirmative statement that covers virtually *all* foreign commerce with respect to the object of the tax at issue.

C. There Has Been No Unambiguous, Affirmative Exercise of the Federal Power to Regulate Commerce That Sanctions California's or Any State's Use of WWCR/Unitary.

Respondent and the courts below rely principally on the Senate's reservation, effectively striking from Article 9(4) of the U.S.-U.K. Tax Treaty[12] any reference to state tax, as the

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[11] Pet. App. B at 16a.

[12] *Supra* note 4; Article 9(4) of the treaty as amended by exchange of diplomatic notes dated April 13, 1976, and presented to the Senate (before application of the reservation) read as follows (bracketed references added):

> Except as specifically provided in this Article:
>
> (a) where an enterprise doing business in one Contracting State [U.S.]:
>
> (i) is a resident of the other Contracting State [U.K.]; or
>
> (ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State [U.K.], and
>
> (b) where the enterprise which is a resident of the other Contracting State [U.K.] is a corporation, such corporation is neither:
>
> (i) a controlled foreign corporation within the meaning of section 957 of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the

unambiguous, affirmative exercise of the Federal power to regulate foreign commerce that sanctions California's use of WWCR/Unitary. That reliance is misplaced. There are important differences between the rejection of Article 9(4) and the adoption of the provisions of the Chicago Convention which were dispositive in *Wardair*. Those differences were, not coincidentally, also the chief reasons for the reservation.

The crucial distinction between this case and *Wardair* is that in *Wardair*, as discussed above, the convention at issue applied to virtually *all* foreign commerce, while here the rejected provisions of Article 9(4) of the U.S.-U.K. Tax Treaty would have applied only to foreign commerce with enterprises located in, or related to enterprises located in, a *single* other nation, namely the U.K. In *Wardair*, because the Federal exercise of the foreign commerce power was an exercise with respect to virtually *all* foreign commerce touched by the state taxation of aviation fuel, the exercise was uniform, rather than piecemeal. The adoption of the Chicago Convention was akin to legislating approval of certain forms of state aviation fuel taxation. The Senate's ratification process gave Congress an opportunity to consider the issue of state aviation fuel taxation as it applies to virtually *all* international air

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general principle thereof); nor

(ii) created or organized under the laws of the first-mentioned Contracting State [U.S.] or of any third State or controlled, directly or indirectly, by a corporation which is a resident of any third State;

then, in determining the tax liability of the first-mentioned enterprise in the State [U.S.] in which it does business, or in a political subdivision or local authority of that State [California], such State [U.S.], political subdivision or local authority [California] shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State [U.K.] or of an enterprise of any third State which is related to the enterprise of the other Contracting State [U.K.], except that this prohibition shall not apply where the first-mentioned enterprise is resident of the first-mentioned Contracting State [U.S.], to the extent that it owns, directly or indirectly, the capital of the related enterprise [in the U.K.].

reprinted in 3 CCH TAX TREATIES ¶ 10,936.

traffic. In this case, on the other hand, the consideration of Article 9(4) of the U.S.-U.K. Tax Treaty gave the Senate no such opportunity to consider the impact of WWCR/Unitary on virtually *all* foreign commerce.

In addition, as presented to the Senate, Article 9(4) would not have prevented California's use of WWCR/Unitary with respect to U.S.-parent multinational groups.[13] The resulting discrimination against U.S.-parent groups with U.K. affiliates further narrowed the already narrow impact of Article 9(4)[14] and may have raised competitiveness concerns about the provision's unbalanced impact on U.S.-U.K. trade and investment.

The too-narrow impact of Article 9(4) is an important reason why Article 9(4) was rejected. Even the sponsor of the reservation, as the court below in *Barclays* points out, objected to Article 9(4) as much for procedural as substantive reasons:

> Explaining one of the motivations behind the reservation, which in effect struck Article 9(4) from the treaty, its chief proponent objected to the Executive Branch use of "the device of a tax treaty" to "impose major changes in internal tax policy" by circumventing Congressional consideration of the State's use of formula apportionment. (Remarks of Sen. Church, 124 Cong. Rec. 18416 (1978).)

Barclays Pet. App. at C-29. The rejection of Article 9(4) therefore, was not approval of California's use of WWCR/Unitary, but rather was an expression of a desire to deal with the matter in a more comprehensive fashion, *e.g.*, by domestic legislation. As then-Senate Minority leader Howard Baker explained:

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[13] *See supra* note 12; *see also* U.S. State Department, Letter of Submittal (June 8, 1976) *reprinted in* 3 CCH TAX TREATIES ¶ 10,938, p. 44,528.

[14] *Cf.* Article 9(4) *as quoted by* the California Supreme Court, *Barclays* Pet. App. at C-28.

> In adopting its reservation to Article 9(4) in June of 1978, the Senate appeared to reach a consensus that domestic legislation, as an alternative to international treaty language, is preferable in regulating that conduct of the States which may affect foreign commerce.[15]

The continuing omission of a provision like Article 9(4) in tax treaties presented for ratification since the U.S.-U.K. Tax Treaty debate simply reflects the desire of both the Executive and Congress to deal with the matter in a comprehensive rather than piecemeal fashion.

D. Since There Has Been No Unambiguous, Affirmative Federal Approval of California's Use of WWCR/Unitary, *Japan Line*'s Two Tests Control This Case; If the California Tax Contravenes Either, It Is Unconstitutional Under the Commerce Clause.

Because Congress has not unambiguously, affirmatively ratified California's use of WWCR/Unitary, this Court must determine whether the Commerce Clause's "self-executing limitation on the power of the states to enact laws imposing substantial burdens on [interstate and foreign] commerce," *South Central Timber*, 467 U.S. at 87, has been violated. Under *Japan Line*, "two additional considerations, beyond those articulated in *Complete Auto*, come in to play" where, as in this case, "a state seeks to tax the instrumentalities of foreign commerce," 441 U.S. at 446. The first is an enhanced risk of multiple taxation. The second is an impairment of Federal uniformity in an area where Federal uniformity is essential. "If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." *Japan Line*, 441 U.S. at 451. California's use of WWCR/Unitary contravenes both.

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[15] COMM. ON FOREIGN RELATIONS REP. ON THE THIRD PROTOCOL TO THE 1975 INCOME TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED, S. EXEC. REP. No. 5, 96th Cong., 1st Sess. 15 (1979), *reprinted in* 3 WG&L TAX TREATIES ¶ 89,075.

II. CALIFORNIA'S USE OF WWCR/UNITARY VIOLATES THE FIRST OF *JAPAN LINE*'S TWO TESTS BECAUSE IT PRESENTS A SUBSTANTIAL RISK OF DOUBLE TAXATION THAT COULD BE ELIMINATED BY THE USE OF REASONABLY AVAILABLE ALTERNATIVES.

In *Japan Line*, this Court held that "[e]ven a slight overlapping of tax -- a problem that might be deemed *de minimis* in a domestic context -- assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." 441 U.S. at 456 (footnote omitted). As Respondent is sure to emphasize, however, that statement is not the end of the analysis on the first *Japan Line* test. This Court in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), added the further requirement that the substantial risk of double taxation presented by the challenged state tax be reasonably avoidable by the taxing state:

> Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing State.

463 U.S. at 189.

A. California's Use of WWCR/Unitary Presents a Substantial Risk of Double Taxation.

For purposes of determining whether California's use of WWCR/Unitary creates a substantial risk of international double taxation, that use "must be evaluated in the realistic framework of the custom of nations." *Japan Line*, 441 U.S. at 454. It must be compared to the allocation or apportionment methods actually used by foreign jurisdictions, since California and this Court are powerless to change those methods. For *Japan Line* analysis purposes, it cannot be evaluated in isolation or in a hypothetical comparison to another jurisdiction using WWCR/Unitary. Since

virtually all foreign jurisdictions use AL/SA,[16] the relevant question is whether the use of WWCR/Unitary creates a substantial risk of double taxation when the entity or affiliated group subject to tax is also subject to tax under AL/SA.[17]

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[16] *See* authorities cited *supra* note 1. The uniform international acceptance of AL/SA for determining corporate income attributable to a national jurisdiction is a product mostly of the post-World War II world economy. Indeed, it is only with the interwoven network of bilateral tax treaties that have developed mostly since the 1950's, JOSEPH ISENBERGH, INTERNATIONAL TAXATION, Vol. II, at 322, 323 (1990), that AL/SA has become not only predominant but mandatory. *See* discussion *infra* p. 19. Early authorizations of formulary apportionment in a multinational setting, therefore, (*e.g.*, *Bass Limited v. Tax Commission*, 266 U.S. 271 (1924)) are not pertinent, since they preceded the relatively recent, mandatory uniform use of AL/SA in the international context.

[17] Even if foreign jurisdictions changed their tax systems to use some version of the unitary method of income apportionment, there would still be a substantial risk of double taxation. *See* Eric J. Coffill and Prentiss Willson, Jr., *Federal Formulary Apportionment As an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?*, 59 TAX NOTES 1103, 1114 (May 24, 1993). One prominent problem arises from different applications of the apportionment factors. For example, a growing number of states (including California) do not use a uniform three-factor (*i.e.*, payroll, property, and sales) formula for apportioning income but rather give extra weight to the sales factor.

> The rationale behind the movement is that it enables the state to "tax the other guy" while at the same time purporting to create a friendly business climate and to promote economic development within the state. For in-state taxpayers who make sales to out-of-state buyers, the double-weighting of the sales factor tends to attribute income out of the state, thereby decreasing the taxpayer's income tax liability to the state of origin. For out-of-state taxpayers who make sales into the state, the double-weighting of the sales factor tends to increase the amount of the taxpayer's income that is attributable to the state. This decreasing of the tax load of in-state citizens at the expense of out-of-state sellers understandably develops fond adherents among politicians who must periodically seek votes from the former but not the latter.

Corrigan, *Weighting the Sales Factor*, MULTI-STATE TAX COMMISSION REVIEW, June 1987, at 9. Were the unitary method to be used worldwide, it could be expected that countries with wage rates one-tenth those prevailing in developed countries would double-, triple-, or even greater weight the payroll factor in order to make up for the disparity, contributing substantially to multiple taxation.

The record below, as well as the record below in the companion case, establishes that significant double taxation has resulted and can easily result when WWCR/Unitary is used domestically and AL/SA is used abroad. Pet. App. F at 88a to 89a; *Barclays* Pet. App. at A-25; *cf. Container*, 463 U.S. at 188. As described in the decision below, Petitioner has argued in this case that California's use of WWCR/Unitary apportioned 70 percent more income to California than would use of AL/SA. Pet. App. B at 20a. While the court below compared this figure to the 250 percent over-apportionment to the state in *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931), and found that the 70 percent over-apportionment did not violate the "external consistency" requirement for apportionment formulas, Pet. App. B at 21a, that finding related only to the "fair apportionment" requirement applicable to all Commerce Clause inquiries, whether interstate or foreign. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The crucial additional inquiry in a foreign commerce case such as this is whether an "overlapping of tax" of that magnitude represents a "substantial risk of double taxation." Such a risk clearly exists in this case.[18]

B. The Use of AL/SA By California Would Virtually Eliminate the Risk of Double Taxation.

California had a reasonable alternative to eliminate the risk of double taxation between itself and foreign jurisdictions created by

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[18] Moreover, this Court should note that, unlike the case with a *property* tax such as that considered in *Japan Line*, the over-apportionment of *income* resulting from a conflict of allocation methods can be infinite on a percentage basis. Where, on an AL/SA basis, a taxpayer in California has a loss (a not uncommon situation for many multinationals in the recent recession), any allocation of positive taxable income via the use of WWCR/Unitary can create, mathematically, an infinite percentage over-apportionment.

its use of WWCR/Unitary. Indeed, like most other states, it now uses that alternative: it allows taxpayers to elect to use AL/SA.[19]

There are two reasons why the use of AL/SA by California in the years at issue would have virtually eliminated the risk of double taxation. First, while the differences between the use of AL/SA among jurisdictions that use that method are not negligible, *see, e.g., Container*, 463 U.S. at 191, those differences are far smaller than the differences that exist in this case, the companion case, and many cases where WWCR/Unitary conflicts with AL/SA. Second, and far more important, the network of U.S. bilateral tax treaties with more than 45 other nations[20] provides a comprehensive and effective mechanism, called competent authority negotiations, to resolve differences in the application of AL/SA by the respective taxing authorities. As described below, this competent authority negotiation process results in elimination of double taxation in the vast majority of cases. If California had used AL/SA in the years at issue it could have, as it and many states do today, "piggybacked" upon the result negotiated by Federal authorities to virtually eliminate the risk that it would tax the same dollar of income being taxed by a foreign jurisdiction.

1. *The Use of AL/SA by California Would Present Far Fewer Opportunities for Double Taxation Than Its Use of WWCR/Unitary Presents.*

Since the potential conflicts between WWCR/Unitary and AL/SA must be analyzed in measuring the risk of double taxation, it is virtually axiomatic that California could substantially reduce that risk by using AL/SA. This is because, notwithstanding the

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19 *See supra* note 2.

20 Included in this number are the republics of the former Union of Soviet Socialist Republics, as to which the Convention for the Avoidance of Double Taxation, June 20, 1973, U.S.-USSR, 27 U.S.T. 1, remains in force. *See* Rev. Proc. 93-22A, 1993-38 I.R.B. 10. Not included are jurisdictions such as Aruba, Bermuda, and the Netherlands Antilles, with respect to which the United States does not have comprehensive double taxation treaties in force.

potential for some double taxation among jurisdictions using AL/SA, the use of a method that is at least theoretically consistent with the system used by all foreign jurisdictions is far less likely to create a risk of double taxation than a method that is theoretically at odds with that method. Moreover, AL/SA is subject to continual refinement by Federal statutory and regulatory amendment with respect to substantive rules,[21] procedural rules for maintaining and supplying relevant information for its enforcement,[22] and penalties.[23] Importantly, these efforts are frequently coordinated by the Federal government with most U.S. tax treaty partners, chiefly through discussions and informal agreement reflected in the work of the Organization for Economic Cooperation and Development (OECD).[24]

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21 *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2561, *et. seq.* (1986) (amending 26 U.S.C. § 482); Prop. Treas. Reg. §§ 1.482-1 and 1.482-2, 57 Fed. Reg. 3571 (1992); Temp. Treas. Reg. §§ 1.482-0T through 1.482-7T (1993); Prop. Treas. Reg. §§ 1.482-1T(f)(2), 1.482-2(g), and 1.482-6T, 58 Fed. Reg. 5310 (1993).

22 *See, e.g.*, Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7403, 103 Stat. 2106, 2358-59 (1989) (amending 26 U.S.C. § 6038A); Prop. Treas. Reg. §§ 1.6038A-0 through 1.6038A-7, 55 Fed. Reg. 50706 (1990); Treas. Reg. §§ 1.6038A-0 through 1.6038A-7 (1991).

23 *See, e.g.*, Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11312, 104 Stat. 1388-1, 1388-454, 1388-455 (1990) (amending 26 U.S.C. § 6662); Prop. Treas. Reg. §§ 1.6662-0, 1.6662-5, 1.6664-0, and 1.6664-4, 58 Fed. Reg. 5304 (1993); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13236, 107 Stat. 312, 505-506 (1993) (amending 26 U.S.C. § 6662).

24 *See, e.g., Model Tax Convention on Income and Capital*, OECD Committee on Fiscal Affairs [hereinafter CFA] (1992) (commentary on Article 9); *Transfer Pricing and Multinational Enterprises*, OECD CFA (1979); *Transfer Pricing and Multinational Enterprises, Three Taxation Issues*, OECD CFA (1984); Internal Revenue Service, *Report on the Application and Administration of Section 482*, App. E, ¶ 10.2 (April 1992), [hereinafter IRS § 482 Report], *reprinted in* BNA DAILY TAX REPORTER No. 70, at S-1, *and also reprinted in* 92 TNT 77-19 (April 10, 1992); *Transfer Pricing Penalties are Discretionary, Treasury Official Says*, TAX NOTES TODAY, Sept. 13, 1993, at 3267 (quoting former IRS Commissioner Shirley D. Peterson as saying the first thing she did as Commissioner "was to travel to Paris and listen to the

2. *The Competent Authority Process Under Tax Treaties Provides a Very Effective Mechanism for Eliminating Any Double Taxation That Does Arise.*

This Court in *Container* noted that "double taxation is sometimes mitigated by provisions in tax treaties providing for intergovernmental negotiations to resolve differences in the approaches of the respective taxing authorities." 463 U.S. at 192 n.31. This mechanism for relieving double taxation by intergovernmental negotiation is known as the competent authority or mutual agreement procedure. *See generally* U.S.-U.K. Tax Treaty, *supra* note 4, art. 25; U.S. Treasury Model Income Tax Treaty,[25] art. 25.

Container accurately identifies the competent authority process as a potential means to achieve consistency among taxing authorities whose basic approach to income allocation is quite similar, *i.e.*, where both use AL/SA. 463 U.S. at 192 n.31. It also appears to conclude, however, that this potential is not achieved because (1) California is not in a position to benefit from the fruits of the competent authority negotiation, and (2) competent authority negotiations are ineffective in generally avoiding double taxation, *Id.* *Amici*, many of whose members have eliminated foreign versus Federal *and* foreign versus state double taxation through the use of the competent authority process, respectfully suggest that the *Container* Court was not adequately informed of the broad availability and effectiveness of competent authority negotiations or of the means by which states can and do adjust state taxable income (and tax) on the basis of such negotiations.

OECD and to U.S. trading partners regarding transfer pricing"); *The U.S. Proposed Regulations Dealing with Tax Aspects of Transfer Pricing Within Multinational Enterprises*, OECD CFA (January 10, 1993), *reprinted in* BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, Jan. 1993, at 21.

[25] U.S. Department of the Treasury, *Model Income Tax Treaty* (1981), *reprinted in* 1 CCH TAX TREATIES ¶ 211 [hereinafter Model Tax Treaty].

A primary goal of the U.S. network of bilateral income tax treaties, like the income tax treaties of other nations, is the mitigation or elimination of double taxation through consistent treatment of transactions by both taxing authorities.[26] Between a corporation and its subsidiary or between two subsidiaries, this is typically achieved through the application of the "Associated Enterprises" article. *See, e.g.*, U.S.-U.K. Tax Treaty, art. 9(1); Model Tax Treaty, art. 9(1).

Paragraph 1 of Article 9 of the typical U.S. tax treaty provides, in effect, that when arrangements between two related enterprises differ from those that would exist between independent enterprises, *i.e.*, the arrangements are not at arm's length, then adjustments may be made so that the arrangements are as they would be if the separate enterprises had bargained at arm's length. Where an income allocation under this authority is made by one country, many treaties require that the other country make a "correlative adjustment," a corresponding decrease in the taxable income of the related party in that jurisdiction to reflect the adjustment made in the other. *See* U.S.-U.K. Tax Treaty, art. 9(2); Model Tax Treaty, art. 9(2). Where one of the countries disagrees with the allocation made by the other, the "competent authorities" must consult and endeavor to reach agreement under the mutual agreement procedures outlined in Article 25 (Mutual Agreement Procedure) of the typical U.S. tax treaty. U.S.-U.K. Tax Treaty, art. 9(3); Model Tax Treaty, art. 9(2). Article 25 also independently provides that a U.S. taxpayer may seek relief from the U.S. competent authority when it considers itself subject to "taxation not in accordance with the provisions of [the treaty]," irrespective of the remedies provided by U.S. domestic law.

This competent authority process is open to all taxpayers confronted with double taxation involving treaty countries or taxation inconsistent with a tax treaty. The procedure for

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[26] IRS § 482 Report, *supra* note 24, at 5-2; American Law Institute, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II -- PROPOSALS ON UNITED STATES INCOME TREATIES 5 (1992) [hereinafter ALI].

implementing and prosecuting a request, Rev. Proc. 91-23, 1991-1 C.B. 534, is as straightforward as any Internal Revenue Service procedure.[27] It is successfully utilized by scores of taxpayers each year.[28] When a request for competent authority assistance under Article 25 is made (whether in the context of an Article 9 adjustment or independently under Article 25), the U.S. competent authority *must*, if the claim is justified, implement a unilateral solution if it is appropriate and, in other cases, *must* attempt to resolve the claim through mutual agreement with the treaty partner.[29] While it is true that an agreement is not mandatory, competent authorities are required to make a good-faith effort to resolve each individual case. *Id.* The U.S. competent authority[30] takes its responsibilities under Articles 9 and 25 of the U.S. income tax treaties seriously:

> Because transfer pricing adjustments have an impact on two or more national tax administrations, the section 482 enforcement process demands a well-functioning process for resolving double taxation cases. Allocation cases involv[ing] transfer pricing issues ... account for about 70 percent to 75 percent of the competent authority case inventory. It is important for taxpayers faced with economic double taxation to have not only a means for seeking relief, but also confidence that the matter will be fairly and expeditiously resolved.[31]

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[27] Rev. Proc. 91-23 superseded Rev. Proc. 82-29, 1982-1 C.B. 481, which had superseded Rev. Proc. 70-18, 1970-2 C.B. 493.

[28] IRS § 482 Report, *supra* note 24, at 5-5.

[29] ALI, *supra* note 26, at 101.

[30] The Secretary of the Treasury or his delegate is designated as the U.S. competent authority in U.S. treaties. *See* Model Tax Treaty, *supra* note 25, art. 3(1)(e)(i). Under Delegation Order No. 114 (Rev. 9), 1990-2 C.B. 326, the U.S. competent authority function has been assigned to the Assistant Commissioner (International) of the IRS.

[31] IRS § 482 Report, *supra* note 24, at 5-2.

Even more important than the seriousness with which the U.S. competent authority takes its responsibility to negotiate in good faith is its exceedingly high rate of success. According to figures provided to Congress, the U.S. competent authority was able in recent years to provide complete relief from double taxation for 77 to 79 percent of the twice-taxed dollars involved, and partial relief for an additional 16 to 19 percent.[32] IRS § 482 Report, *supra* note 24, at 5-5. Thus, in fiscal 1991, for example, full or partial relief from double taxation was provided through the competent authority process for over $500 million (representing 96 percent of the dollars at issue) that, but for the competent authority process, would also have been subject to tax in another jurisdiction. *Amici* respectfully suggest that a failure rate of competent authority negotiations as low as 4 to 5 percent indicates that the competent authority process presents just the sort of "central coordinating authority" (that eliminates any substantial risk of double taxation between two jurisdictions both using AL/SA) found wanting in *Container*, 463 U.S. at 192.

3. *The Advance Pricing Agreement Procedure Provides Another Effective Mechanism to Avoid Double Taxation.*

While the competent authority process has historically been used to deal with the resolution of disputes that arise upon the examination of past tax years, a relatively new process has developed, also under the authority of Articles 9 and 25 of the typical bilateral U.S. tax treaty, to achieve agreement between U.S. and foreign tax authorities on allocations of income in advance. This process, known as the Advance Pricing Agreement or APA process, is described in Rev. Proc. 91-22, 1991-1 C.B. 526. Under the APA process, a taxpayer first negotiates with the IRS to determine the applicable transfer pricing methodology and the acceptable range of results in applying that methodology to the taxpayer's situation. Then the IRS, under the mutual agreement

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[32] Thus, through negotiations, either the foreign jurisdiction or the U.S. (or both) reduced taxable income.

authority contained in the U.S. bilateral tax treaties, negotiates with a foreign tax authority. When both tax authorities are in agreement, the tax authorities and the taxpayer enter into a "closing agreement"[33] that binds the tax authorities and the taxpayer for a period of several years in the future. In this fashion, taxpayers and both U.S. and foreign tax authorities can agree in advance to appropriate allocations and avoid future disputes.

While the APA program is less than three years old, and intended chiefly for larger taxpayers with more complicated cases, it appears to be successful. The IRS Director of the program has reported that there are currently 49 taxpayers engaged in the APA program at various stages and that eight completed APAs have involved competent authority agreements with foreign tax authorities.[34]

4. *Were California to "Piggyback" Off the Federal Determination of Income, As Most States Do, It Could Take Advantage of the Competent Authority and Advance Pricing Agreement Processes to Virtually Eliminate the Risk of Double Taxation.*

Container is correct in its statement that California is in no position itself to negotiate with foreign governments regarding potential allocation disputes. 463 U.S. at 192 n.31. It is also technically correct that neither *tax treaties* nor *Federal law* provides a mechanism by which the U.S. Federal competent authority can directly negotiate double taxation arising out of state tax systems. *Id.* What was not taken into account in *Container*, however, is that most *state income tax laws* (including California's today) provide effective mechanisms to take advantage of the

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[33] A closing agreement is a written agreement between a taxpayer and the IRS relating to the taxpayer's tax liability. 26 U.S.C. § 7121.

[34] Robert Ackerman *et al.*, *The Advance Pricing Agreement (APA) Program: A Model Alternative Dispute Process*, 2 TAX MANAGEMENT TRANSFER PRICING, Special Report No. 9, 6 (December 1, 1993).

success of the competent authority and APA processes. These mechanisms ensure conformity between Federal treatment of potential double tax problems, as resolved through competent authority or APA proceedings, and state tax treatment. Taken together, and given the high success rate of double tax elimination at the Federal level, these mechanisms effectively eliminate the risk of double taxation of income between the states and foreign jurisdictions. This simple, effective, and widely used means to avoid double tax between states and foreign jurisdictions gives California today (and gave it in the years at issue) a more than "reasonably available alternative" to avoid double tax within the meaning of *Container*, 463 U.S. at 189.[35]

First, more than forty states (including California today) begin their taxable income calculations with an amount based on Federal gross income, net income, or taxable income figures.[36] Any subsequent final changes or corrections made to Federal tax items, due either to amendment of the Federal return or to assessment or refunds by Federal authorities, trigger obligations to notify the appropriate state tax commission promptly.[37] Any such Federal adjustments trigger an appropriate adjustment to state tax liability,

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[35] The availability of this mechanism also belies the suggestion that use of AL/SA would require California to defer automatically to allocation determinations made by various foreign governments. *Cf. Container*, 463 U.S. at 193.

[36] ALL STATES TAX HANDBOOK, ¶ 221 (Mendoza, Klutkowski, Curammeng, and Vassallo, eds., 1992), [hereinafter ALL STATES HANDBOOK]. *See, e.g.*, PA. STAT. ANN. tit. 72, § 3420n-2 (1981 & Supp. 1993); FLA. STAT. § 200.12 (1990 & Supp. 1992); ILL. ANN. STAT., ch. 35, ¶ 5/203 (Smith-Hurd 1993); N.J. REV. STAT. § 54:10A-4 (1986 & Supp. 1993); N.Y. TAX LAW § 208(9) (Consol. 1986 & Supp. 1993).

[37] ALL STATES HANDBOOK ¶ 232. *See, e.g.*, PA. STAT. ANN. tit. 72, §§ 7406 and 7407 (1990 & Supp. 1993) (within 30 days); FLA. STAT. § 220.23 (1990 Supp. 1992) (within 60 days); ILL. ANN. STAT., ch. 35, ¶ 5/506 (Smith-Hurd 1993) (within 120 days); N.J. REV. STAT. § 54:10E-11 (1986 & Supp. 1993) (within 90 days); and N.Y. TAX LAW § 211 (Consol. 1986 & Supp. 1993) (within 90 days).

in the form of either an additional assessment by the state tax authorities or a refund claim by the taxpayer.[38]

As an added measure of reliability in conforming state tax assessments with Federal tax liability, many states utilize tax information sharing provisions. Pursuant to 26 U.S.C. § 6103(d), Federal tax returns and return information are open to inspection by, or disclosure to, any state agency, body, or commission charged under the laws of such state with responsibility for administration of state tax laws. Similarly, most states have enacted parallel provisions, providing for disclosure to the IRS of tax information received by state tax administrations.[39]

California itself has enacted mechanisms to ensure consistency of state tax treatment with negotiated positions of the U.S. competent authority, at least with respect to its taxpayers electing to use the water's edge/unitary method. Under California's tax law,[40] corporate franchise taxable income is defined as net income, which itself is defined as gross income less deductions. "Gross income," in turn, means gross income under 26 U.S.C. § 61, except as modified by the state.

If any taxpayer's Federal gross income or deductions for any tax year of any taxpayer are changed or corrected by the "Commissioner of Internal Revenue or other officer of the United States or other competent authority," or if the Federal tax return is amended, the taxpayer must report to California the change, correction, or amendment. CAL. REV. & TAX. CODE § 25432 (West 1992 & Supp. 1993). If a Federal change is made and a

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[38] *See, e.g.*, PA. STAT. ANN. tit. 72, § 7407 (1990 & Supp. 1993); FLA. STAT. § 220.23 (1990 & Supp. 1992); ILL. ANN. STAT., ch. 35, ¶¶ 5/903 and 5/905 (Smith-Hurd 1993); N.J. REV. STAT. §§ 54:49-6 and 54:49-14 (1986 & Supp. 1993); and N.Y. TAX LAW §§ 1081, 1083, and 1087 (Consol. 1987 & Supp. 1993).

[39] ALL STATES HANDBOOK, ¶ 235.

[40] CAL. REV. & TAX. CODE §§ 24271 and 24341 (West 1992 & Supp. 1993).

report is timely filed, a state claim for credit or refund may be filed, CAL. REV. & TAX. CODE § 26073.4, or, if the change is adverse to the taxpayer (and whether or not a report is filed), deficiencies may be assessed by the state, CAL. REV. & TAX. CODE §§ 25673, 25674.

Upon the resolution of double tax issues by the U.S. competent authority and resulting adjustments to Federal returns, correlative adjustments to state returns will be made in more than 40 "piggyback" states, thus giving consistent effect to the decision of the competent authority and virtually eliminating any substantial risk of double taxation between the state and foreign jurisdictions.

III. CALIFORNIA'S USE OF WWCR/UNITARY PREVENTS THE FEDERAL GOVERNMENT FROM SPEAKING WITH ONE VOICE, THUS VIOLATING THE SECOND OF *JAPAN LINE*'S TWO TESTS.

A. California's Use of WWCR/Unitary Impairs a Uniform Federal Policy Favoring AL/SA.

The second *Japan Line* test provides that a state tax will violate the Foreign Commerce Clause if it "impair[s] federal uniformity in an area where federal uniformity is essential," 441 U.S. at 448, thus preventing the Federal government "from 'speaking with one voice' in international trade." 441 U.S. at 452; *see also Container*, 463 U.S. at 193. The evidence indicates that there is a uniform Federal policy favoring AL/SA and disfavoring WWCR/Unitary.

As noted by this Court in *Container*, 463 U.S. at 184, the Federal government has adopted AL/SA for Federal income tax purposes. In addition, the United States has entered into a broad network of bilateral double tax treaties which require use of AL/SA for Federal and foreign tax purposes and require correlative adjustments when income is re-allocated to reflect arm's

length arrangements.[41] Moreover, contrary to the apparent understanding of this Court in *Container*, 463 U.S. at 196 & n. 35, and of the California Court of Appeal in its initial decision below, Pet. App. E at 58a, U.S. treaties do *not* waive the requirement to use AL/SA with respect to the U.S. taxation of U.S. corporations. While the so-called "saving clause" of U.S. tax treaties[42] generally preserves the U.S. government's right to tax domestic corporations as if the treaty did not exist, specific exceptions to the saving clause guarantee U.S. corporations the right to be taxed under AL/SA by the United States, as well as access to the mutual agreement procedure to enforce that right.[43] These exceptions reflect the understanding that such treaty rights would be meaningless if they did not apply to U.S. corporations for U.S. tax purposes.[44] In fact, the United States has acknowledged U.S. residents' entitlement to these treaty benefits even if the relevant treaty does not contain an explicit exception from the saving clause to cover them.[45] Domestic corporations

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[41] *See* discussion *supra* p. 19.

[42] *E.g.*, Model Tax Treaty, *supra* note 25, art. 1(3) (General Scope).

[43] Thus, Article 1 (General Scope) of the Model Tax Treaty, *supra* note 25, provides in relevant part as follows:

> 3. Notwithstanding any provision of this Convention *except paragraph 4*, a Contracting State may tax its residents ... as if the Convention had not come into effect ...
>
> 4. The provisions of paragraph 3 shall not affect:
>
> (a) the benefits conferred by a Contracting State under *paragraph 2 of Article 9 (Associated Enterprises)* ... and under *Article ... 25 (Mutual Agreement Procedure)* ....

(emphasis added).

[44] *See, e.g.*, 1 J. Ross McDonald, ANNOTATED TOPICAL GUIDE TO U.S. INCOME TAX TREATIES 186 (1993); ALI, *supra* note 26, at 230; 2 New York University, Proceedings of the Fortieth Annual Institute on Federal Taxation, § 31.04[3] (1982).

[45] *See, e.g.*, U.S. Department of the Treasury, *Technical Explanation to U.S.-Trinidad and Tobago Tax Treaty* (1970), *reprinted in* 3 CCH TAX TREATIES ¶ 9750, p. 43,024-25.

are entitled to these treaty benefits without regard to whether they are subsidiaries of foreign parent corporations or parents of foreign subsidiaries.

Thus, by its use of WWCR/Unitary, California contradicts an international taxing method which the Federal government has both universally applied and sought the universal commitment of its treaty partners to apply as well.

B. California's Use Of WWCR/Unitary Prevents the Federal Government From Speaking With One Voice In an Area Where Federal Uniformity Is Essential.

WWCR/Unitary violates the "one voice" standard because it "implicates foreign policy issues which must be left to the Federal Government." *Container*, 463 U.S. at 194. As this Court has noted, foreign commerce is "preeminently a matter of national concern." *Japan Line*, 441 U.S. at 448. The Federal government's uniform policy of offering and demanding the use of AL/SA throughout its substantial treaty network amply demonstrates the national significance of the choice of taxing method.

The fact that neither Federal legislation nor any treaty *directly* prohibits the states' use of WWCR/Unitary may indicate that the Federal government has not acted with preemptive force, but it in no way lessens the obligation to consider the national interest in speaking with one voice. As this Court noted in *Container*, the most obvious foreign policy implication of WWCR/Unitary is that it could offend foreign governments and lead them to retaliate against the United States as a whole, 463 U.S. at 194. Any uncertainty this Court may have had about its competence to evaluate the risk of foreign retaliation when it considered *Container* in 1983 should have evaporated by 1993, in light of the concrete actions toward retaliation that various governments have

taken in the interim.[46] Moreover, these threats of retaliation are not wholly restricted to displeasure over the application of WWCR/Unitary to foreign-parent multinationals.[47]

In considering the interest of foreign governments in the level of California's taxation of domestic corporations in *Container*, this Court stated that "the amount of tax a domestic corporation pays is much more the function of California's tax rate than of its allocation method," and that the Court "can only assume" that a foreign government's sense of offense would be "attenuated at best" regardless of whether California imposed a certain tax liability by way of WWCR/Unitary or through simply raising its corporate tax rate, 463 U.S. at 195. *Amici* respectfully submit that *Container's* assumption was not well-founded.

Governments' foreign economic policy interests in preventing double taxation encompass *both* protecting their corporations' investments abroad *and* attracting corporate investors from abroad into their own marketplace.[48] Thus, the interest of foreign governments in seeing that U.S. corporations are not subjected to double taxation as a result of WWCR/Unitary is two-fold: (1) ensuring that such double taxation is not a barrier to the ability of foreign-parent multinationals to invest and compete on a level playing field in the United States, and (2) ensuring that it is not a barrier to the ability of U.S.-parent multinationals to invest and compete on a level playing field in foreign countries. In the case of foreign-parent multinationals, their U.S. subsidiaries will not be able to compete on equal terms with local companies in the

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[46] *See* Supplemental Brief of Petitioner on Petition for a Writ of *Certiorari*, *Barclays Bank PLC v. Franchise Tax Board*, No. 92-1384, at 3-5.

[47] *See, e.g., Resolution of the Finance Committee of the German Bundestag Concerning Unitary Taxation in the State of California*, July 1, 1993, *reprinted in* 7 TAX NOTES INTERNATIONAL 165, 93 TNI 135-23 (July 19, 1993).

[48] This duality of interests (*i.e.*, in the ability of domestic-based investors to compete abroad and in the ability of foreign-based investors to compete in the host country) is a well recognized reason for governments' decisions to enter into bilateral tax treaties. *See, e.g.*, ALI, *supra* note 26, at 1-2.

marketplace of a WWCR/Unitary jurisdiction if the U.S. subsidiaries' taxable income is liable to be inflated through WWCR/Unitary, beyond that of their purely local competitors, by inclusion of profits which have been earned by foreign affiliates and taxed abroad. In the case of U.S.-parent multinationals, they will be less able to establish foreign subsidiaries that can compete on equal terms with local companies in the foreign jurisdiction if some of the income earned by the foreign subsidiary and taxed abroad is also currently attributed to the U.S. parent under WWCR/Unitary and subjected to additional tax, not suffered by their foreign competitors, in the WWCR/Unitary jurisdiction. In both cases, it is the *allocation method* of the WWCR/Unitary jurisdiction, and not its *tax rate*, which is the cause of the concern. Thus, foreign governments have just as much reason to object to California's use of WWCR/Unitary as applied to U.S.-parent multinationals as they do with respect to foreign-parent multinationals.

Moreover, as this Court has noted, a state tax "may, of course, have foreign policy implications other than the threat of retaliation." *Container*, 463 U.S. at 195. In this case, contrary to the view expressed by the court below, Pet. App. E at 58a to 61a, the Federal government has a foreign commerce interest in the extent to which WWCR/Unitary prevents U.S.-parent multinationals from competing effectively in foreign marketplaces.[49] California's use of WWCR/Unitary undermines this interest because it causes simultaneous, unrelieved double (*i.e.*, foreign and California) taxation of the income of the U.S. multinationals' foreign subsidiaries, thereby placing them at a competitive disadvantage versus purely foreign corporations in the *foreign* market. Nothing comes closer to the heart of the concerns underlying the Commerce Clause. Citing "the principle of ensuring competitive balance among similarly situated businesses," the Executive Branch, through the Treasury Department, has on

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[49] This interest is quite independent of the Federal desire to ensure competitive balance for U.S.-parent and foreign-parent multinationals in the *domestic* marketplace.

numerous occasions announced its opposition to states' application of WWCR/Unitary to both foreign-parent and U.S.-parent multinationals.[30]

CONCLUSION

California's use of WWCR/Unitary in the years at issue created a substantial risk of double taxation that could have been avoided through the use of reasonably available alternatives, as it is today through the use of AL/SA and "piggybacking" off Federal competent authority negotiations. The use of WWCR/Unitary also interferes with a uniform Federal policy favoring AL/SA that is essential to avoid impediments to international trade and unfair tax treatment of U.S. multinational corporations. Since the Federal government has not unambiguously and affirmatively approved California's use of WWCR/Unitary, this Court should reverse the California Court of Appeal and hold that California's use of WWCR/Unitary violates the Commerce Clause.

Respectfully submitted,

PHILIP D. MORRISON*
MARY C. BENNETT
KIMBERLY J. TAN
BAKER & MCKENZIE
815 Connecticut Avenue, N.W.
Washington, D.C. 20006
(202) 452-7000

*Counsel of Record

Of Counsel:
J. PAT POWERS
BAKER & MCKENZIE
660 Hansen Way
Palo Alto, CA 94304
(415) 856-2400

Counsel for National Foreign Trade Council, Inc. and Emergency Committee for American Trade

December 15, 1993

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[30] *See Barclays* Pet. App. at A-64; Hearings before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm. 3 (1986) (testimony of J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy)), *microformed on* Doc. 86-6319 (Tax Analysts).

Supreme Court, U.S.
FILED
DEC 15 1993
OFFICE OF THE CLERK

Nos. 92-1384 and 92-1839 (Consolidated)

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Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

KENDALL L. HOUGHTON
Counsel of Record
WILLIAM D. PELTZ
ELIZABETH C. BURTON
Chair, and Vice-Chair, Lawyers' Coordinating Subcommittee
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-8103

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation as *amicus curiae* in support of the petitioner in the above-captioned matter, as well as in the matter of *Colgate-Palmolive Co. v. Franchise Tax Board*, Docket No. 92-1839, which matter has been consolidated for hearing purposes with *Barclays Bank PLC v. Franchise Tax Board*. Written consents of the petitioners and respondents have been obtained and filed with the Clerk of the Court.

INTEREST OF *AMICUS CURIAE*

The Committee on State Taxation ("COST") is a non-profit association that was organized in 1969 as an advisory committee to the Council of State Chambers of

Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 400 major multistate corporations engaged in interstate and international business. COST's principal objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Virtually all of COST's members are engaged in business in the State of California, and many of these corporations are members of unitary groups—both foreign-parent groups and domestic-parent groups with foreign subsidiaries—that have been subject to California's worldwide reporting method. Moreover, many COST member companies were directly and adversely affected by the threatened and real retaliatory measures imposed by foreign nations in response to California's use of a taxing method that encroached upon their sovereignty. Therefore, COST has an interest in the instant case.

SUMMARY OF ARGUMENT

Every nation in the world, including the United States, has chosen to assert its taxing jurisdiction over nondomiciliary corporations by reference to arm's length/separate accounting, a method which respects the sovereignty of other nations wherein multinational corporations may conduct business giving rise to taxable income. The United States sanctions this method of taxation of foreign commerce because (i) it cannot give offense to our trading partners, but instead fosters mutually beneficial commercial and political relations; (ii) the taxing method's prerequisite that transactions cross national borders ensures that jurisdiction to tax is unimpeachable; and (iii) it has been the basis of this nation's treaty representations to foreign nations concerning the type and degree of administrative burdens and tax liabilities that the United States will impose on foreign commerce.

The foreign Commerce Clause was originally drafted and has since been interpreted by this Court to provide special protection to domestic business from any foreign retaliation that results when a state ventures on its own to tax foreign commerce in a way that, being inconsistent with federal policy in this regard, prevents the federal government from "speaking with one voice" when regulating foreign commerce. In this case, California has chosen to impugn the United States' sanctioned method of taxing commerce by imposing forced worldwide combined reporting and its concomitant administrative and compliance burdens upon many unitary foreign affiliates without any direct contact with California. This jurisdictional affront has resulted in the very retaliatory threats and measures by foreign nations that the Framers feared in a system without uniform federal regulation of foreign commerce, but that the Framers intended the foreign Commerce Clause to rectify. California's use of forced worldwide combination cannot withstand scrutiny under the foreign Commerce Clause and is therefore unconstitutional.

The practical significance of this issue to domestic business is further illustrated by the fact that several states in addition to California have adopted various forms of forced worldwide combination. These states have tools available to them to impose tax on any income of a corporation that arises from activities conducted in their jurisdictions but that has been shifted to an inappropriate taxing jurisdiction; therefore such encroachments on the sovereignty of other nations are both unnecessary and unjustifiable, by reference to the foreign Commerce Clause.

ARGUMENT

I. THE HISTORY AND PURPOSE OF THE FOREIGN COMMERCE CLAUSE AND ITS ROLE IN REGULATING THE CONDUCT OF MULTINATIONAL COMMERCE AND COMMERCIAL RELATIONS UNDERSCORES THE UNCONSTITUTIONALITY OF CALIFORNIA'S ADOPTION OF FORCED WORLDWIDE COMBINED REPORTING

Article I, sec. 8, cl. 3 of the United States Constitution reserves to Congress the power "to regulate Commerce with foreign Nations and among the several states." James Madison summarized the prevailing view of the Framers in this regard in The Federalist: "If we are to be one nation in any respect, it clearly ought to be in respect to other nations." THE FEDERALIST No. 42, at 279 (J. Madison) (J. Cooke ed. 1961). His peer Alexander Hamilton commented more specifically on the import of the federal power to regulate foreign commerce:

> The want of a power to regulate commerce is by all parties allowed to be of the number [of defects in the pre-Constitutional Federal system]. . . . The want of it has already operated as a bar to the formation of beneficial treaties with foreign powers; and has given occasions of dissatisfaction between the States. *No nation acquainted with the nature of our political association would be unwise enough to enter into stipulations with the United States by which they conceded privileges of any importance to them, while they were apprised that the engagements on the part of the Union, might at any moment be violated by its members;* and while they found from experience that they might enjoy every advantage they desired in our markets, without granting us any return, but such as their momentary convenience might suggest.

THE FEDERALIST No. 22, at 135-137 (A. Hamilton) (J. Cooke ed. 1961) (emphasis added). Foreign commerce—particularly as represented by the Union's commercial

relations with Great Britain—continued to be a focus of concern and debate at the Convention to adopt the Constitution; one analysis of the defensibility of the dormant interstate Commerce Clause doctrine notes that the Commerce Clause limits on protectionism in foreign trade and commerce in transit are much more strongly supported in the Convention records than are such limits in interstate trade. *See*, R. COLLINS, Economic Union as a Constitutional Value, 63 N.Y.U. L. Rev. 43, 54 (1988).

Concern for foreign commerce protectionism has continued to have a high profile. This Court has acknowledged that the Commerce Clause, "by its own force created an area of trade free from interference by the States" and "even without implementing legislation by Congress is a limitation upon the power of the States." *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 328 (1977). Moreover, with regard to foreign commerce, the "constitutional prohibition against state taxation . . . is broader than the protection afforded to interstate commerce . . . because matters of concern to the entire nation are implicated." *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, —— U.S. ——, ——, 112 S. Ct. 2365, ——, 60 U.S.L.W. 4582, 4584 (1992); *see also Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 n.13 (1979) (citing other Supreme Court cases recognizing this distinction); J. HELLERSTEIN, State Taxation I, Corporate Income and Franchise Taxes ¶ 4.14[2] (1983).

This Court articulated the "more extensive constitutional inquiry" to be made where the foreign Commerce Clause is implicated by a state taxing method in *Japan Line*. Two additional considerations distinct to taxes impacting foreign commerce supplement the four-prong interstate Commerce Clause test set out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). First, notwithstanding apportionment, the state tax may not create a "substantial risk of international multiple taxation," *Japan Line*, 441 U.S. at 451. Second, a state

tax may not "impair federal uniformity in an area where federal uniformity is essential," by preventing the federal government from " 'speaking with one voice when regulating commercial relations with foreign governments.' " *Id.* at 448, 451. Impairment of federal uinformity is demonstrated where foreign nations disadvantaged by the state tax retaliate against American-owned entities or instrumentalities present in the foreign jurisdictions. *Id.* at 450.

It has ever been the understanding of the domestic business community that the foreign Commerce Clause protected it from the ramifications of state encroachment on federal commerce regulatory powers, including the power to determine the appropriate method of taxing foreign commerce. As multi-national commerce carried on by domestic corporations has evolved and developed under the auspices of the foreign Commerce Clause and as the potential for sovereign taxing systems to encroach one upon the other becomes more significant, the need for speaking "in one voice" as to matters of taxation of foreign commerce has become even more critical. Where a state does encroach upon the sovereignty of another nation, the foreign countries that are thus disadvantaged (*i.e.*, through the imposition of economic and administrative burdens on their domiciliary business entities) typically regard such incursions as a system-wide rather than a state-specific offense for purposes of response thereto. In this case, the United Kingdom has retaliated generally against domestic business with United Kingdom contacts; only a portion of such domestic business actually has contacts with California, and that portion by their very nature will have many or most contacts elsewhere. Thus, the entire core of domestic business having nexus with retaliating nations, and the states that have taken care to observe the tenets of federal policy, bear the brunt of retaliatory measures.

Barclays has demonstrated that the retaliatory measures against which American business rightly expects the federal Commerce Clause to provide protection have occurred in this case, and will reoccur if forced worldwide combination is not declared unconstitutional. The rejection by California of the federal (and indeed international) mandate of arm's length/separate accounting to divide international income for tax purposes and the State's substitute imposition of forced worldwide combination, has culminated in threats and acts of retaliation from 1978 forward of a magnitude beyond that previously experienced in this country. As documented in the *Barclays* trial record and acknowledged by the California Court of Appeal (a point completely ignored by the California Supreme Court), diplomatic protests were lodged with the United States by almost every developed country in the world, including direct protestations by Prime Minister Thatcher of the United Kingdom, Prime Minister Nakasone of Japan, and Prime Minister Trudeau of Canada directly to the President. The United States experienced significant problems in negotiating treaties with the Dutch and Germans, due to those countries' disfavor of California's taxing method. The Canadian and French treaty negotiators insisted on an exchange of notes which obligated the United States to reopen discussion with each country on the subject whether an acceptable solution could be devised. Trial Exs. 1 pp. 28-29, 32A, 32EE, 37F, 43, 46D, 46H, 72; Ct. of App. Slip. Op. at p. 40.

Madison and Hamilton's predictions two centuries ago were correct. The strongest reactions to and retaliatory measures against California's use of forced worldwide combination were registered by Great Britain, the nation whose commerce and trade strength instilled the greatest fear in the drafters of the foreign Commerce Clause. Great Britain followed up its early diplomatic efforts with respect to the aberrant California situation with the en-

actment in 1985 of retaliatory legislation that would deny certain previously agreed-upon treaty benefits to United States corporations operating in unitary states. At that time, the only recourse for American businesses to avoid the effect of such legislation—*i.e.*, not repatriating the dividends of United Kingdom subsidiaries—was unsatisfactory or harmful to their business operations, from the viewpoint of many. The passage of the water's edge legislation by California in 1988 stayed the implementation of Great Britain's retaliatory legislation but the threat of the implementation remained and was brought into play in 1993. Great Britain then notified targeted business entities as to the means and effect of implementation and United States corporations were faced with the economic burden of the proposed retaliation.

What are the ramifications of foreign retaliation against a state's unconstitutional taxing method for COST's member companies? Ensuring international, federal and state tax compliance becomes impossible. If companies are forced to devise alternative contingency plans to accommodate their shifting duties and liabilities every time a state taxing measure provokes threatened or real international retaliation, the evaluation of ongoing business and the evaluation of business opportunities becomes a guessing game rather than a business analysis. The ability to operate at all in various foreign countries often hinges on the nature of relations between the United States and such countries from moment to moment. The foreign Commerce Clause is the only shield domestic corporations can raise against the brunt of foreign economic retaliation that is deflected from the errant state and falls on corporations which have no culpable ties to the state.

The forced use of worldwide combined reporting is especially offensive to foreign nations and multinational businesses because it is wholly unnecessary. The entire world, with the exception of six states of the United States, manages to operate effective tax systems without thrusting

onerous record-keeping and compliance requirements on entities with no transactional or legal contact with the state that would impose those requirements. This Court has stated that as between arm's length/separate accounting and worldwide combination there is little to recommend one system over the other. *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 184-185 (1983). Whatever merit that conclusion may have in other contexts, in the context of foreign commerce there are at least three circumstances that favor the use of arm's length/separate accounting. First, it is the method chosen by every national government, so its use is not capable of giving rise to any objection by any trading partner. Second, it is least likely to impinge on the sovereignty of any other nation because it concerns itself only with those transactions that by their cross-border nature invite that concern; it does not impose accounting and compliance burdens on entities whose activities have no contact with the taxing jurisdiction. Third, it is the method that the actions of the United States have led its trading partners to believe will be used to determine all tax liabilities and compliance requirements in the United States.

II. FORCED WORLDWIDE COMBINED REPORTING IS BEING UTILIZED BY SEVERAL STATES RATHER THAN INTERNATIONALLY SANCTIONED TOOLS; IN NO CASE IS THE METHOD EITHER NECESSARY OR JUSTIFIABLE

The practical importance of the question whether forced worldwide unitary combination is constitutional remains unabated by a state's "hit and run" ploy of instituting an unconstitutional tax measure and later repealing or reforming such legislation on the eve of (i) retaliatory action by a foreign nation or (ii) plenary judicial review by a state supreme court or by this Court. Although the Solicitor General claims to view *Barclays* as lacking "substantial recurring importance," *Am.* U.S. Br. No. 92-1384,

due to the State's enactment of water's edge legislation, this perspective is willfully myopic. In fact, the actual and potential utilization of worldwide combined reporting by states in addition to California continues to threaten the well-being of domestic business in the context of the world marketplace.

Alaska imposes forced worldwide combination on oil and gas companies. ALASKA STAT. § 43.20.073(f). Tennessee imposes worldwide combination on financial institutions. TENN. CODE ANN. § 67-4-817(d). While an election out of worldwide combination is available in Idaho, Montana, North Dakota and Utah, specific features of these states' methods may in effect force corporate taxpayers back into worldwide combined reporting, or include select foreign affiliates in the combined group. For instance, the Idaho State Tax Commission may disregard a water's edge election if any corporation is deemed to have failed to comply with the domestic disclosure spreadsheet requirement or the State's legal and procedural requirements. IDAHO CODE § 63-3027B(c). *See also* MONT. ADMIN. R. 42.26.224; *cf.* N.H. REV. STAT. ANN. § 77-A:6, IV. North Dakota includes foreign corporations in a unitary group that files a water's edge election, if over 50% of the voting stock of the foreign corporations is owned directly or indirectly by an affiliated corporation and more than 20% of the average of its payroll and property is assignable to locations in the United States (not specifically North Dakota). N.D. CENT. CODE §§ 57-38.4-01 and 57-28.4-02. Effective taxable years beginning on or after January 1, 1994, Utah includes 100% of a foreign operating company's income (prior law included 50%) on a water's edge combined report. UTAH CODE ANN. § 59-7-304(1).

Each of the above-referenced states has a tool or a policy which it could effectively utilize to reach income that has been shifted to an inappropriate taxing jurisdiction. These means may be utilized without encroaching on the

sovereignty of other nations and precipitating the retaliation that would attend that encroachment. As noted above, this tool has been sanctioned by the entire world.

CONCLUSION

For the reasons set forth above, the Committee on State Taxation respectfully requests that the decisions of the California Supreme Court in *Barclays* and *Colgate-Palmolive* be reversed.

Respectfully submitted,

KENDALL L. HOUGHTON
Counsel of Record
WILLIAM D. PELTZ
ELIZABETH C. BURTON
Chair, and Vice-Chair, Lawyers' Coordinating Subcommittee
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-8103

Supreme Court, U.S.
FILED
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OFFICE OF THE CLERK

No. 92-1839

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BRIEF OF *AMICI CURIAE* CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, NATIONAL ASSOCIATION OF MANUFACTURERS, AND UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS IN SUPPORT OF PETITIONER

Of Counsel:
ROBIN S. CONRAD
MONA C. ZEIBERG
NATIONAL CHAMBER LITIGATION CENTER, INC.
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

JAN S. AMUNDSON
NATIONAL ASSOCIATION OF MANUFACTURERS
1331 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 637-3055

TIMOTHY B. DYK
Counsel of Record
BETH HEIFETZ
JONES, DAY, REAVIS & POGUE
1450 G Street, N.W.
Washington, D.C. 20005
(202) 879-3939

DAVID E. COWLING
JONES, DAY, REAVIS & POGUE
2001 Ross Avenue
Dallas, Texas 75201
(214) 220-3939

Counsel for Amici Curiae

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

No. 92-1839

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California, Third Appellate Circuit

BRIEF OF *AMICI CURIAE* CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, NATIONAL ASSOCIATION OF MANUFACTURERS, AND UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS IN SUPPORT OF PETITIONER

INTEREST OF THE AMICI CURIAE*

The *amici curiae* are strongly committed to principles of domestic and international free trade. Each is concerned that California's taxation of multinational businesses under a world-wide combined reporting method creates significant international economic conflicts that will impede trade artificially and restrict the flow of capital in global markets, dampening both foreign investment in the United States and United States investment abroad. In addition, worldwide combined reporting imposes

* The parties' letters of consent have been filed with the Clerk of this Court pursuant to this Court's Rule 37.3.

substantial burdens, both financial and administrative, on multi-jurisdictional companies engaged in foreign commerce. These *amici* believe that *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), was wrongly decided and should be overruled.

The **Chamber of Commerce of the United States of America** is the largest federation of business companies and associations in the world. With substantial membership in each of the 50 states, the Chamber represents approximately 220,000 businesses and organizations and serves as a major voice of the American business community. It has a strong interest in tax measures that affect the competitiveness of U.S. industry and the U.S. economy.

The **National Association of Manufacturers** (NAM) is a non-profit voluntary business association comprised of more than 12,000 manufacturing and related businesses operating in the United States and worldwide. NAM supports a taxing system that encourages the competitiveness of U.S. manufactured goods in domestic and foreign markets.

The **United States Council for International Business** advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce, the Business and Industry Advisory Group to the Organization for Economic Development and Cooperation, and the International Organization of Employers. The Council officially represents U.S. business positions in the

main intergovernmental bodies and in dealings with foreign business and foreign governments. Working with its membership of approximately 300 corporations, law firms, and associations, the Council addresses policy issues affecting an increasingly globally oriented American business community. Its objective is to promote an open system of world trade, finance, and investment.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case, together with No. 92-1384, *Barclays Bank PLC v. Franchise Tax Board*, also pending before the Court, presents important questions concerning the scope and viability of this Court's decision in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). In *Container*, the Court upheld California's combined reporting approach to the taxation of U.S.-based corporations with foreign subsidiaries. Under that approach, a taxpayer's net income is calculated on the basis of all phases of the operation of an enterprise, even where accomplished through separately incorporated entities located outside the jurisdiction.

In *Barclays Bank*, the petitioner notes that *Container* reserved the issue of worldwide combined reporting with respect to foreign-owned multinationals, and urges that, under well-established doctrine, the holding of *Container* cannot constitutionally be applied to foreign parents. In this case, the petitioner urges that, if *Barclays* is decided in favor of the taxpayer, the Constitution requires that similar protection be afforded to domestic parent corporations with foreign subsidiaries.[1] These *amici* agree with the petitioners in both *Barclays* and *Colgate*. However, these *amici* suggest that this Court adopt a more direct and coherent solution to this complex problem -- that it simply overrule its decision in *Container*.

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[1] In addition, Colgate raises cogent points concerning the absence of congressional consent to and the presence of a clear federal directive concerning California's regime. *Amici* agree with these arguments.

This Court has consistently subjected state actions affecting foreign commerce to exacting scrutiny beyond that applied to state actions affecting only interstate commerce. Thus, in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), this Court expressly held that a state tax provision that affects foreign commerce is unconstitutional if it creates a risk of multiple taxation. Burdens on foreign commerce of this sort undermine the profound constitutional commitment to free trade among nations.

In *Container*, there was no dispute, and this Court agreed, that California's combined reporting method applied worldwide resulted in double taxation. Nonetheless, the tax was sustained. This did not signal a retreat from the *Japan Line* test; to the contrary, in the years following *Container*, the Court regularly has relied on *Japan Line*'s risk of multiple taxation test to measure the constitutionality of state taxes. The inconsistency of *Container* with other decisions of this Court, the unworkability of *Container*, changed global circumstances, and the absence of any reliance interests in the retention of *Container* compel the conclusion that *Container* should be overruled.

ARGUMENT

These cases arise at a time when the United States is endeavoring to eliminate barriers to global commerce. The risk that state laws in general and state taxes in particular will burden international trade has long been clear. Indeed, the Framers of the Constitution provided special protection for foreign commerce (U.S. Const. art. I, § 8, cl.3) and this Court has long recognized that, where foreign commerce is concerned, limits on state authority must operate with special force. *See Japan Line*, 441 U.S. at 446; *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 283 (1976); *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 445-46 (1827). It is against this backdrop of heightened constitutional concern over foreign commerce and relations with foreign nations that the propriety of state taxing actions must be assessed.

I. *CONTAINER* WAS WRONGLY DECIDED.

This Court's decision in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), should be overruled. In *Container*, although conceding that California's use of worldwide combined reporting for U.S.-based multinationals resulted in actual double taxation -- the touchstone for determining constitutionality -- this Court held that the tax did not violate the foreign commerce clause. These *amici* respectfully suggest that the decision was erroneous.

A. The Development Of Combined Reporting Demonstrates Its Impropriety When Applied Worldwide.

At issue in these cases, as in *Container*, is California's method of worldwide combined reporting. The Court's jurisprudence in this area begins with the "unitary" principle. Ever since companies began operating across state lines, the question of the division of income for tax purposes has been present. While states may, consistent with the Constitution, look beyond their borders to "get the true value of the things within it," this Court has long held that the Constitution does not permit this authority "to open to taxation what is not within the State." *Wallace v. Hines*, 253 U.S. 66, 69 (1920).

The "unitary" concept arose in the late 19th century as a mechanism for dealing with the interstate enterprise engaged in transportation or communication. The value of railway tracks or telegraph wires in a state may exceed the actual cost of such property, because a mile of track or wire does not take into account that it is the enterprise as a whole that confers value. *See Allied-Signal v. Director, Div. of Taxation*, 112 S.Ct. 2251, 2258 (1992); *State Railroad Tax Cases*, 92 U.S. 575, 608 (1876). Under the unitary theory, a state could assess a tax by valuing the entire property -- both within and without the state -- as a unit and, through application of a formula, fairly determine the taxing state's share of that value. *See, e.g., Western Union Telegraph Co. v. Taggart*, 163 U.S. 1, 18 (1896); *Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18, 26 (1891).

The Court approved the application of the unitary principle to enterprises lacking physical unity, *see Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220-21 (1897), and thereafter, to corporate income. In the income tax context, the unitary principle accounted for the fact that a corporation's profits are often earned by a series of transactions beginning with manufacture in one state and ending with sales in other states. *See Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-21 (1920); *United States Glue Co. v. Oak Creek*, 247 U.S. 321, 328-29 (1918). Where income accrues through multistate activities, a single state's taxable share is determined by apportioning a part of the corporation's total income from unitary operations.[2] The apportionment of income is typically based on the so-called "three factor formula" -- the ratio of the taxpayer's in-state payroll, property, and sales to the total payroll, property, and sales of the unitary business. *See Butler Bros. v. McColgan*, 315 U.S. 501, 505-07 (1942).

The next step in the evolution of the unitary business principle was utilizing it in conjunction with combined reporting of multistate income. Under the combined reporting method, "each member of a group carrying on a unitary business computes its individual taxable income by taking a portion of the combined net income of the group," whether or not the members of a group are wholly separate corporate subsidiaries or branches of the same

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[2] Although the terms "allocation" and "apportionment" are sometimes used interchangeably to describe the division of income among various jurisdictions, "allocation" properly refers to the "attribution of a particular type of income or receipt or property or the like to a designated State, [and] 'apportionment' refers to the division of the tax base by formula." Jerome R. Hellerstein & Walter Hellerstein, *State Taxation I: Corporate Income and Franchise Taxes* ¶ 9.01, at 9-5 n.1 (2d ed. 1993).

corporation. *Caterpillar Tractor Co. v. Department of Revenue*, 618 P.2d 1261, 1262-63 (Ore. 1980).[3]

California has taken that approach further. Under its world-wide unitary combination method, California looks to income earned anywhere, here or abroad, by separate corporate entities, foreign- or domestic-based, engaged in unitary operations. California then apportions that entire worldwide income in determining the tax obligation of the in-state company. *See Container*, 463 U.S. at 162-63.[4]

At the time of *Container*, combined reporting appeared to be non-controversial in the domestic context. Given the stricter standard for judging compliance with the foreign commerce clause set out in *Japan Line*, combined reporting in the foreign context was anything but accepted. Indeed, the federal tax system, along with the systems in all other countries and in most states, was and is based on a very different theory. While the federal government taxes all income earned by United States corporations (and permits the filing of consolidated returns where common ownership standards are satisfied) it takes a different approach in the foreign context.[5] Pursuant to this approach, the income of

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[3] A number of states currently require combined reporting for domestic unitary businesses (*see, e.g.*, Arizona, California), while others provide for it under certain circumstances (*see, e.g.*, Michigan, New York). 1 State Tax Guide (CCH) ¶ 10-110 at 1071-72. Combined reporting may be required by statute, by regulation, or by directive of the taxing authority.

[4] Of the states requiring combined reporting on a U.S. basis, few extend that requirement to the international arena. *See* 1 State Tax Guide (CCH) ¶ 10-110 at 1071-72.

[5] In a consolidated return, the separate entities of the various member corporations are disregarded, the consolidated income of the entire group is reported on a single return, and a single tax is paid on that income. E. George Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171, 197 (1970).

separate corporate entities is computed separately, with any transactions among them valued as if they had been conducted by unrelated entities.

To avoid possible tax distortions, the "transfer-pricing" provisions of Section 482 of the Internal Revenue Code were enacted. *See* 26 U.S.C. § 482. Section 482 permits "distribution, apportionment or allocation" of income among entities "owned or controlled directly or indirectly by the same interests," including non-U.S. companies, "in order to . . . reflect the income of such organizations . . . ." *Id.*[6] Detailed implementing regulations were first adopted in 1968 and that approach, refined over time, has continued to the present day. Treas. Reg. 1.482-1 *et seq.* (as amended in 1993); Temp. Treas. Reg. 1.482-1T *et seq.* (1993).

In the more than ten years since *Container*, the Court has not revisited the worldwide combined reporting issue. The matter, however, is far from settled. Courts in states that use worldwide combined reporting have been confronted with countless challenges, both with respect to foreign- and domestic-based multinationals,[7] and foreign governments have registered significant opposition. *See infra* at pp. 20-21.

B. *Container* Is Inconsistent With This Court's Earlier Decision In *Japan Line*.

In *Container*, the Court considered the California tax against the backdrop of its earlier decision in *Japan Line*. There, California had imposed a tax on containers used solely in international commerce. In holding the tax in *Japan Line* unconstitutional, the Court first looked to the standards used to

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[6] The Internal Revenue Code contains other protections against distortions that may arise from the separate accounting method. *See, e.g.*, 26 U.S.C. §§ 551-58, 951-64.

[7] *See, e.g.*, 4 Cal. Tax Rptr. (CCH) 20,701-722 (listing cases involving worldwide combined reporting pending before the Franchise Tax Board).

measure a tax that implicates interstate interests. To satisfy the Constitution, a state tax on interstate commerce must (1) be applied to an activity with a substantial nexus with the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to services provided by the state. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Although the tax in *Japan Line* satisfied those *Complete Auto* standards, the Court stressed that where foreign commerce is concerned, additional considerations come into play: "When construing Congress' power 'to regulate Commerce with foreign Nations,' a more extensive constitutional analysis is required." *Japan Line*, 441 U.S. at 446.

The additional consideration relevant here is whether the state tax at issue creates a "risk of multiple taxation." *Id.*[8] Although the Court in the interstate context can make certain "that no instrumentality of commerce is subjected to more than one tax on its full value" (*id.* at 447), on the international level, the Court is unable to provide that same protection. As a result, even a "fairly apportioned" state tax "may subject foreign commerce to the risk of a double tax burden . . . which the commerce clause forbids." *Id.* at 448 (internal quotations and citations omitted). Considered against that standard, the Court held the tax in *Japan Line* unconstitutional.

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[8] The second additional consideration is whether the state tax "may impair federal uniformity in an area where federal uniformity is essential." *Japan Line*, 441 U.S. at 448. Uniformity may be frustrated if "international disputes over reconciling apportionment formulae . . . arise" or through retaliation due to an asymmetry in the international tax structure caused by a "novel state tax." *Id.* at 450. In striking down the tax in *Japan Line*, the Court noted that although Congress had not expressly precluded states from taxing "instrumentalities of foreign commerce," the Customs Convention on Containers evidenced federal policy and demonstrated the federal commitment to uniformity. *Id.* at 452.

Container presented a question virtually identical to that in *Japan Line*.[9] Engaged in foreign commerce, the Container Corporation paid tax to foreign countries on income earned abroad. 463 U.S. at 187. At the same time, it was subjected to California's worldwide combined reporting tax, derived by reference to the same income on which foreign governments levied taxes.

The Court conceded that the record in *Container* revealed not simply a risk of multiple taxation, but that there was multiple taxation in fact: "some of the income taxed without apportionment by foreign nations as attributable to [Container's] foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part." 463 U.S. at 187. As in *Japan Line*, that multiple taxation arose from "a serious divergence in taxing schemes adopted by California and the foreign taxing authorities." *Container*, 463 U.S. at 187.

Applying the clear standards of *Japan Line*, the California tax appeared unquestionably unconstitutional. Nonetheless, the Court upheld the tax although by only a narrow margin and over a strongly-worded dissent.[10] To do so, the Court devised a new limitation on the double taxation prohibition -- it applies only if the double taxation is "inevitable." 463 U.S. at 188. Double taxation is inevitable, and therefore unconstitutional, only if "one taxing jurisdiction claimed the right to tax a given value in full, and another taxing jurisdiction claimed the right to tax the same entity in part . . . ." *Id.* Because the multiple taxation in

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[9] The constitutional questions posed by the worldwide combined method had come before the Court nearly two years earlier in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.* Although set for reargument at the time the Court noted probable jurisdiction in *Container Corp.*, *Chicago Bridge* subsequently was dismissed by the Court for want of a substantial federal question. 463 U.S. 1220 (1983).

[10] In *Container*, five justices of this Court voted in the majority, and three joined in dissent. Justice Stevens did not participate.

Container -- although quite real -- resulted from two jurisdictions applying different methods of dividing the tax base, rather than from one jurisdiction attempting to tax the entire base, multiple taxation was not "inevitable" (*id.* at 188-89) and therefore, the Court held, the tax withstood constitutional scrutiny.

The Court devised a second limitation on the multiple tax doctrine: a taxing method proposed as an alternative must be guaranteed not to result in any overlap of taxation. 463 U.S. at 191. Because even variations in the application of the arm's-length method might create some overlap, worldwide combined reporting was constitutional. The Court also noted that the tax considered in *Container* was imposed on income, while *Japan Line* concerned a property tax, and that the tax in *Container* was imposed on a U.S. parent corporation, not on a foreign-based multinational. Neither distinction did anything to obviate the fact of actual double taxation in *Container*. *Id.* at 187-88. Finally, the Court suggested that California could achieve the "same economic result" through "rais[ing] its general tax rate . . . ." *Id.* at 195.

The dissent systematically assailed the Court's opinion. First, the double taxation constituted a clear violation of the foreign commerce clause. 463 U.S. at 198 (Powell, J., dissenting). That such taxation was not "inevitable" was immaterial -- "it arises because California has rejected accepted international practice in favor of a tax structure that is fundamentally different in its basic assumptions." *Id.* at 201. As a result, "it is inevitable that the state will tax income under its formula that has already been taxed by another country under accepted international practice." *Id.* at 200.

Next, to the claim that alternatives to California's system might still result in some double taxation, the dissent recognized that the differences in application "are not inherent in the 'arm's-length' system," and are likely to be resolved as international practice becomes more refined. *Id.* at 200-01 (Powell, J., dissenting). Nor was it meaningful that California could have collected the same revenues from Container simply by raising its tax rates.

Political realities would constrain California from raising its general tax rate. *Id.* at 203-04. California could hardly raise the tax rate as to a single taxpayer, or even as to all corporations engaged in foreign commerce, without encountering constitutional attacks under the commerce and equal protection clauses. *Id.*

II. UNDER THIS COURT'S PRECEDENTS *CONTAINER* SHOULD BE OVERRULED.

As this Court recognized just three Terms ago, "when governing decisions are unworkable or are badly reasoned, this Court has never felt constrained to follow precedent." *Payne v. Tennessee*, 111 S.Ct. 2597, 2609 (1991) (internal quotation omitted). In the area of state regulation or taxation of business activities, this Court has, where appropriate, overruled precedents under both the due process and commerce clauses to bring case law into line with coherent doctrine and current factual context. *See id.* at 2609-10 & n.1.

This Court has relied on a variety of considerations in determining whether to overrule a prior decision. In addition to considering whether the precedent provides a workable standard (*see, e.g., Swift & Co. v. Wickham*, 382 U.S. 111, 124-25 (1965)), the Court has looked also to whether the decision is out of step with constitutional doctrine (*see, e.g., Payne v. Tennessee*, 111 S.Ct. at 2909-10), whether the factual context has changed since the precedent was decided (*see, e.g., Goodman v. Lukens Steel Co.*, 482 U.S. 656, 659-62 (1987); *Patterson v. McLean Credit Union*, 491 U.S. 164, 173 (1989)), and whether overruling the precedent would frustrate legitimate reliance interests. *See, e.g., Monell v. Department of Social Servs.*, 436 U.S. 658, 700 (1978). Each of these considerations compels the conclusion that *Container* should be overruled.

A. The Result In *Container* Is Doctrinally Anomalous.

1. The Distinction Between Income And Property Tax In This Context Is Unsound.

To avoid the rule of *Japan Line* -- that a multiple tax violates the foreign commerce clause -- this Court noted that an income tax, rather than a property tax, was at issue in *Container*. 463 U.S. at 188. In support of this distinction, the Court cited language from its decision in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 445 (1980). There, Mobil had challenged Vermont's apportioned tax on dividend income on the ground that New York, the state of commercial domicile, was empowered to tax the same income in full.

Three points are essential: first, the unitary principle itself was developed in the property tax context, and the four-prong test against which the *Japan Line* property tax was considered was borrowed from *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which involved not a property tax but rather a franchise tax on gross receipts. Second, there was no multiple taxation in *Mobil*, because New York imposed no tax at all on the income. Third, the *Mobil* distinction simply acknowledged that property in some situations may be allocated to a single site, while income, whether from dividends or operations, is usually apportioned among the jurisdictions that give rise to the income. But that property may lend itself to allocation rather than apportionment has no relevance to the question present in *Container* and here -- whether there is a risk of multiple taxation. The Constitution is indifferent to how a tax was calculated, so long as the calculation does not result in taxation of out-of-state values. *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940); *cf. Trinova Corp. v. Michigan Dep't of Treasury*, 111 S.Ct. 818, 831 (1991) (difference between methods of calculating tax "is one of form and lacks constitutional significance"). One unmistakable indication of taxation of out-of-state values is that a corporation is twice taxed on precisely the same value. Whether it occurs with respect to income or property, such double taxation is unconstitutional. *Container*'s reasoning is therefore anomalous.

2. The Double Taxation "Inevitability" Requirement Is Inconsistent With This Court's Precedents.

In the years since *Japan Line*, the Court repeatedly has held that the risk of multiple taxation will defeat a tax on foreign commerce clause grounds. Just three Terms ago, the Court reiterated that the Constitution is "a defense against state taxes which . . . give rise to serious concerns of double taxation. . . ." *Trinova Corp. v. Michigan Dep't of Treasury*, 111 S.Ct. at 836. And last Term, this Court upheld Tennessee's tax on the lease of containers used in international shipping, pointing to the tax credit offered by Tennessee for taxes paid elsewhere which effectively "reduces, if not eliminates, the risk of multiple international taxation." *Itel Containers Int'l Corp. v. Huddleston*, 113 S.Ct. 1095, 1104 (1993).

The notion that double taxation must be "inevitable" in order to be unconstitutional makes no sense where there is actual multiple taxation. The theory of the majority in *Container* appeared to be that if double taxation did not always result from California's approach, it was irrelevant that it resulted in double taxation in the case before the Court. This suggests a return to a formalism long abandoned in the area of state taxation. With the singular exception of *Container*, in modern times this Court has insisted on an approach to commerce clause questions based on "economic realities" (*Complete Auto*, 430 U.S. at 279) and on "the practical effect of a challenged tax." *Mobil Oil Corp.*, 445 U.S. at 443.[11]

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[11] The *Container* notion that worldwide combined reporting is unconstitutional only if there is a guarantee that alternate methods will not produce any double taxation comports neither with economic realities nor with constitutional doctrine. While differences in arm's-length methodology may create some tax overlap, they result in little variation in tax liability. *See* Richard L. DeLap, *From Moorman to Chicago Bridge: U.S. Supreme Court Decisions Relating to "Unitary" Taxation*, 2 J. St. Tax. 197, 212-13 (1983-84). Moreover, perfection in apportionment has never constitutionally been required, *see Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978), and a constitutionally-infirm tax cannot be saved simply because alternatives are less than perfect.

Moreover, considered against this Court's state tax jurisprudence, the "inevitability" requirement could never be satisfied in the context of a tax on the income of a unitary business. However egregious, so long as one country is not trying to tax all of the entity's income, no tax could be found to violate the foreign commerce clause. But the constitutional concern that states may be taxing value beyond their borders is implicated whenever multiple taxation occurs, without regard to the particular mathematical niceties from which the multiple taxation arose.

In all events, while the tax does not necessarily result in double taxation in every case, it is nonetheless "inevitable," because it rests on the three-factor formula, whose logic falters when applied internationally. *Container*, 463 U.S. at 202 (Powell, J., dissenting). The theory underlying the three-factor formula, and indeed the basis for its acceptability for interstate commerce clause purposes, is that a dollar of payroll or property or a dollar of sales made in the state produce roughly the same amount of taxable income as a dollar in another state.[12] It is fully recognized that the three-factor formula is only a "rough . . . approximation" of profits (*see Trinova*, 111 S.Ct. at 833), and this Court has acknowledged that neither it nor other apportionment formulas will produce a figure that represents the actual profits earned within a state. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

This approximation of the proper division of interstate income is constitutionally tolerable within a country where the commer-

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[12] The three-factor formula is based on the proportion of a unitary business' total payroll, property and gross receipts located in the taxing state. To determine the portion of income of a multinational that is apportionable to (and presumably taxable by) California, the total worldwide income of the unitary company is multiplied by a fraction which is the average of the three ratios of in-state payroll, property, and sales to total payroll, property, and sales. *See Mobil Oil Corp.*, 445 U.S. at 429-30 n.4, 437 n.13.

cial economy may be considered sufficiently homogeneous. *Cf. Trinova Corp. v. Michigan Dep't of Treasury*, 111 S.Ct. at 833 (permitting departures from three-factor formula in domestic context). But the shortcomings of the three-factor formula in the interstate context are severely exacerbated when transferred to the international arena. Indeed, the assumption of homogeneity applied to the income of a multinational group works serious distortions.

There are marked differences between wages paid and the costs of property in the United States and in other countries. *See* Jerome R. Hellerstein & Walter Hellerstein, *State Taxation I: Corporate Income and Franchise Taxes* ¶ 8.10[3][c] (2d. ed. 1993) (hereafter "*State Taxation*"). Products and markets vary significantly from one country to the next. Thus, application of the three-factor formula leads to a shifting of a disproportionate share of the foreign source income to state taxation. Profit rates differ as well; whenever they are higher in foreign affiliates than in domestic activities, the result is a disproportionate tax on foreign corporations. Indeed, it is widely recognized that the use of the three-factor formula with respect to foreign commerce "result[s] in severe distortion and misattribution to the state of income that, by any acceptable standard, should be attributed to foreign countries." *Id.* at ¶ 8.14[8] at 8-156.[13] As the dissent in *Container* recognized, "[s]ince California is a jurisdiction where wage rates, property values, and sales prices are relatively high, double taxation is the logical expectation in a large proportion of the cases." *Container*, 463 U.S. at 202 (Powell, J.,

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[13] In dismissing a similar argument in *Container*, the Court rejected the profitability figures provided to illustrate the distortion, on the ground that they were calculated using the arm's length method, which does not provide a perfect picture of income. *Container*, 463 U.S. at 181-82. This is an unworkable result. While arm's-length, like formulary apportionment, is an "imperfect prox[y]" (*id.* at 182), there is no way other than by means of a comparison to demonstrate that formulary apportionment works unfairly in a particular context.

dissenting). Under this Court's precedents, that is an expectation that constitutionally is unacceptable.

3. *Container's* Suggestion Of Disparate Treatment Of Domestic Companies Is Constitutionally Unsupportable.

The holding of *Container* is as inappropriate for Colgate as it is for Barclays. Regardless of the domicile of the multinational, it is undoubtedly foreign income that is being taxed. *See Container*, 463 U.S. 202 (Powell, J., dissenting). And, as the dissent in *Container* acknowledged, "such a tax has the effect of discouraging American investment [abroad]," *id.*, a result not only likely to invoke the ire of certain trading partners, but one that is directly contrary to consistent federal policy, most recently demonstrated by the Executive Branch's negotiation and congressional approval of the North American Free Trade Agreement.

The multiple taxation that results from worldwide combined reporting, *see supra* at 14-16, affects domestic and foreign-based multinationals alike. The Court is in no better position "to enforce full apportionment by all potential taxing bodies" (*Japan Line*, 441 U.S. at 447) in the case of a domestic-based multinational than it is with respect to a foreign-based multinational.[14]

Equal treatment of domestic and foreign-based multinationals is consistent with the underpinnings of the foreign commerce clause. As this Court has recognized, "[i]n granting to Congress

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[14] In the interstate context, because the Court is able "to enforce full apportionment by all potential taxing bodies" (*Japan Line*, 441 U.S. at 447) and because "multiple burdens logically cannot occur" (*Washington Revenue Dep't v. Association of Washington Stevedoring Cos.*, 435 U.S. 734, 746-47 (1978)), apportionment formulas need only meet a basic "fairness" test in order to satisfy the Constitution. In the international context, however, there is no "authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value . . . ." *Japan Line*, 441 U.S. at 447-48.

the right to regulate commerce with foreign nations . . . the Framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities . . . by the people of the states with citizens and subjects of foreign governments." *Cook v. Pennsylvania*, 97 U.S. 566, 574 (1878). The need to safeguard that zone of free exchange has led this Court to hold that the commerce clause prohibits preferring one form of "protected" commerce over another. *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 333 (1977). The prohibition operates with added strength here, where such discrimination would result in a "diminution of free competition, [which is] wholly inconsistent with the free trade purpose of the Commerce Clause." *Id.* at 336. Those disincentives represent clear encroachments on the constitutional commitment to unencumbered foreign commerce.

In addition to discouraging investment abroad, a distinction between foreign-based and domestic-based multinationals would have the perverse result of permitting California "to discriminate against a Delaware corporation in favor of an overseas corporation." *Container*, 463 U.S. at 203 (Powell, J., dissenting). That sort of undermining of the level playing field would run afoul of the Equal Protection Clause as well. A tax classification is constitutionally permissible only if it "'rest[s] upon some ground of difference having a fair and substantial relation to the object of the legislation.'" *Allied Stores of Ohio v. Bowers*, 358 U.S. 522, 527 (1959) (quoting *Royster Guano Co. v. Virginia*, 253 U.S. 412, 415 (1920)). The classification here is, of course, whether the foreign commerce can be traced back to a foreign or domestic parent. The object of the legislation, it appears, is simply the raising of revenue.

Raising of revenue is certainly critical to any government. *See Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue*, 460 U.S. 575, 586 (1983). But that interest, standing alone, cannot justify discriminatory treatment; generating revenue is a purpose of every tax. For equal protection purposes, the classification of taxpayers must have "a fair and substantial

relation to a constitutional non-fiscal object . . . ." *New York Rapid Transit Corp. v. City of New York*, 303 U.S. 573, 587 (1937). California can point to no object that would justify a tax on the foreign income of U.S.-corporations that is not imposed on the foreign income of foreign-based corporations.[15]

B. *Container* Is Unworkable In Practice.

The substantial administrative burdens on foreign commerce that result from worldwide combined reporting demonstrate that *Container* is unworkable in practice. California's deviation from the internationally accepted method imposes enormous accounting and administrative burdens on taxpayers with affiliates in both California and foreign countries. The foreign corporations that are included in a worldwide unitary group are often not otherwise taxable in the United States; indeed, they may not have any transactions with any U.S. entity. As a result, those corporations have no reason to maintain books and records in a manner consistent with local practices, or on a basis reflecting the three-factor formula. *See* Mortimer M. Caplin & Robert H. Elliot, *State Taxation of Multi-National Corporations After Container Corp.* 170-71 (1983). The use of worldwide combined reporting thus imposes a wholly separate recordkeeping system on companies solely for the purpose of meeting California's unusual approach.

Worldwide combined reporting imposes other administrative burdens as well. Differences among states in implementing of the three-factor formula[16] and in making unitary determinations often require both the parent corporation and its foreign subsidiaries to submit substantial information to each taxing state. *See* Paul J. Hartman, *Federal Limitations on State and Local Taxation* § 9:31,

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[15] That distinction would lead to significant administrative disputes, as there is no settled definition of foreign ownership.

[16] State statutes applying the three-factor formula for interstate apportionment are "studded with variations." *State Taxation*, ¶ 9.06 at 9-23 n.72 and Table 9-1 at 9-8.

at 623 (Supp. 1992). Foreign corporations must prepare and maintain records in United States currency, taking into account the many different exchange rates applicable to various foreign subsidiaries, as well as sharp fluctuations of value. *See* Charles E. McLure, Jr., *Economic Perspectives on State Taxation of Multijurisdictional Corporations* 206-07 (1986). Foreign laws regarding secrecy often make this information difficult to assemble. *See* Caplin & Elliot, at 3.

Such computations and recordkeeping requirements are a costly and burdensome administrative expense that amount to a barrier to foreign commerce -- precisely what the foreign commerce clause was designed to prevent. This Court has recognized that a State statute that has the effect of requiring out-of-state competitors to alter their established practices in order to engage in commerce in the state constitutes a constitutionally proscribed burden on free commerce. *See Hunt v. Washington Apple Advertising Comm'n*, 432 U.S. 333, 351 (1977). The rule of *Container* thus works affirmative harm to the values that are central to this Court's commerce clause jurisprudence -- harm that looms increasingly larger "in this era of substantial international trade." *Kraft General Foods v. Iowa Dep't of Revenue*, 112 S.Ct. 2365, 2373 (1992) (Rehnquist, C.J., dissenting).

C. Changed Circumstances Require That *Container* Be Overruled.

In the decade since *Container*, our trading partners have forcefully communicated their disfavor with California's departure from the international norm. Indeed, California's deviation has provoked significant -- and serious -- reaction from U.S. trading partners. The United States "has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world."

Pet. App. at H45.[17] The displeasure of other countries is thus resoundingly clear, a circumstance that counsels overturning *Container*.

In direct response to California's taxation, the United Kingdom adopted retaliatory legislation in 1985, the effect of which is to impose a double taxation burden on U.S. parent companies operating in states employing the worldwide combined taxing method. *Id.* at B22-23. If the legislation is implemented, those companies will no longer be entitled to certain tax benefits relating to the payment of dividends by U.K. subsidiaries. *Id.*[18]

The retaliation takes other forms as well. Some nations have cancelled trade missions to states using worldwide combined reporting. *Id.* at B23. In addition, tensions over this issue have "seriously complicated our economic relations with many of our closest allies" and have been "partially responsible for stalling some bilateral tax treaty negotiations." *Id.* at H45. These events demonstrate a change in circumstances from the time of *Container* and provide a clear basis for overturning that decision.

D. The Presence Of Reliance Interests Provides No Ground For Declining To Overrule *Container*.

Respondent cannot advance any substantial reason for preserving the erroneous rule laid down in *Container*. The

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[17] Citations to Pet. App. refer to the Appendix to the Petition for Writ of Certiorari in No. 92-1384, *Barclays Bank PLC v. Franchise Tax Board*.

[18] The retaliatory legislation already has injured U.S.-based companies. The possibility of retroactive penalties "impelled many American companies into pre-implementation compliance" (*id.* at B23), with the result that some companies have foregone benefits to which they are entitled under the terms of federally-negotiated treaties. Pet. App. H45.

decision has been sharply criticized since its inception,[19] and challenges from both foreign and domestic multinationals have long been part of the state court landscape. *See supra* at p. 8 n. 7. Moreover, any reliance interests California could assert would be no different from those present in other cases in which this Court has nevertheless overruled commerce clause precedent that has been unworkable or unsound. *See, e.g., McKesson Corp. v. Division of Alcoholic Beverages*, 496 U.S. 18 (1990). And this process of doctrinal evolution, especially in the commerce clause area, is a familiar and expected part of the constitutional regime under which states operate. *See Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 473 (1959) (Frankfurter, J., dissenting).

Significantly, unlike taxpayers faced with a change in tax law, states have a variety of remedies available to avoid disruptions. *See Harper v. Virginia Dep't of Taxation*, 113 S.Ct. 2510, 2519 (1993); *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. at 39-40. For example, states may provide relief only to those taxpayers who paid under protest, or they may "enforce relatively short statutes of limitation applicable to [refund] actions." *Id.* at 45.[20]

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[19] Opposition to worldwide combined reporting has been widespread and vocal. In fact, as a result of that opposition, California in 1988 enacted legislation permitting a corporate taxpayer engaged in a worldwide unitary business to elect to compute its California franchise tax liability generally on the basis of its United States, as opposed to its worldwide, operations. *See* Cal. Rev. & Tax Code § 25110 (West 1992). Recent amendments liberalize in certain respects the use of this "water's-edge" approach. Cal. S.B. 671, 1993-94 Reg. Sess. (Oct. 6, 1993), 1993 Cal. Legis. Serv. 3877 (West). These changes also suggest that holding the worldwide combined tax unconstitutional will not interfere with reliance interests, as California already has a new approach in place.

[20] In California, credits or refunds must be sought within "four years from the last day prescribed for filing the return . . . or after one year from the date of the overpayment," whichever is later. Cal. Rev. & Tax Code § 26073 (West 1992 & Supp. 1993).

In any event, a state's interest in fiscal stability, although certainly legitimate, does not justify denying relief for its constitutional violations. Under this analysis, *Container*, which was decided by a narrow margin and over a "spirited dissent[]" (*Payne v. Tennessee*, 111 S.Ct. at 2610-11) should be overruled.

CONCLUSION

For the foregoing reasons, this Court's decision in *Container Corp. v. Franchise Tax Board* should be overruled and the judgments of the courts below should be reversed.

Respectfully submitted,

Of Counsel:
ROBIN S. CONRAD
MONA C. ZEIBERG
NATIONAL CHAMBER LITIGATION CENTER, INC.
1615 H Street, N.W.
Washington, D.C. 20062
(202) 463-5337

TIMOTHY B. DYK
Counsel of Record
BETH HEIFETZ
JONES, DAY, REAVIS & POGUE
1450 G Street, N.W.
Washington, D.C. 20005
(202) 879-3939

JAN S. AMUNDSON
NATIONAL ASSOCIATION OF MANUFACTURERS
1331 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 637-3055

DAVID E. COWLING
JONES, DAY, REAVIS & POGUE
2001 Ross Avenue
Dallas, Texas 75201
(214) 220-3939

December 16, 1993

Counsel for Amici Curiae

[redacted]

[redacted]

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD,
an Agency of the State of California,
Respondent.

[redacted]

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
an Agency of the State of California,
Respondent.

[redacted]

On Writs of Certiorari to the Court of Appeal of the State of California, for the Third Appellate District

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[redacted]
IN SUPPORT OF
[redacted]
FRANCHISE TAX BOARD BY THE
STATE OF NORTH DAKOTA AND THE STATES OF
HAWAII AND KANSAS

Of Counsel:

Douglas A. Wald
Assistant Attorney General
[redacted]
[redacted]
[redacted]
Bismarck, ND 58505

M.K. Reid Heitkamp
North Dakota Attorney General
Counsel of Record
State Capitol
600 E. Boulevard
Bismarck, ND 58505
Attorney for Amici

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QUESTION PRESENTED

Whether there is evidence of a federal policy of allowing the States to use the worldwide combined report accounting method so as to remove these cases from a Dormant Commerce Clause analysis.

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Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
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COLGATE-PALMOLIVE COMPANY,
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vs.
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On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY THE STATE OF NORTH DAKOTA AND THE STATES OF HAWAII AND KANSAS

INTEREST OF AMICI CURIAE

Amici are States which compute the tax liabilities of multijurisdictional business under the "unitary business

principle." Amici have a direct interest in the question of when this Court's dormant Commerce Clause analysis applies and when actions of the Legislative and Executive Branches of the Federal Government establish that a State tax is permitted.

In 1986, this Court broke new ground in the analysis of State taxes under the Commerce Clause in its decision in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986). This Court applied that decision again in the 1992-93 term in *Itel Containers International Corp. v. Huddleston*, 507 U.S. ___ (1993), 122 L.Ed.2d 421. Amici have a continuing interest in the application of *Wardair* and *Itel* to State taxes.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of Respondent, Franchise Tax Board, State of California. Consent to the filing of this brief has not been requested from the parties because the amici filing this brief are the Attorneys General of their respective States. Rule 37.5.

SUMMARY OF ARGUMENT

This Court's decision in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), establishes a framework to evaluate whether the actions of the Legislative and Executive Branches of the Federal Government permit a State tax law.

The Federal Government's actions in the circumstances of this case evidence a federal policy permitting the State tax at issue in these cases. Congress has considered the issue of worldwide combined reporting and the United States Senate has rejected a treaty prohibition on this tax practice. In addition, the Executive Branch, by its actions, has permitted worldwide combined reporting.

California's use of worldwide combined reporting (hereinafter referred to as WWCR) should be affirmed.

ARGUMENT

IT IS THE POLICY OF THE FEDERAL GOVERNMENT, DRAWN FROM FEDERAL LAW, TO PERMIT THE STATE TAXES HERE AT ISSUE

In *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), the Court found the Federal Government's policy, reflected by government action and inaction, was to affirmatively permit sales taxes imposed on aviation fuel used by foreign airlines in international travel. Based upon this finding, the Court determined that a dormant Commerce Clause analysis, and specifically the "one voice" element, was inappropriate. "It would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow." (Court's emphasis.) 477 U.S. at 12.

Wardair provides guidance on the factors to be considered by courts when determining United States policy regarding state taxation. The Court analyzed three items: 1) the Chicago Convention on International Civil Aviation; 2) a Resolution adopted by the International Civil Aviation Organization, an organization of which the United States is a member; and 3) 70 bilateral agreements entered into by the

United States with other foreign governments.[1] With respect to these items, the Court held:

1. The Chicago Convention "precludes the imposition of local taxes on fuel only when the fuel is 'on board an aircraft . . . on arrival . . . and retained on board on leaving' . . . it does not prohibit taxation of fuel purchased." *Ibid.* The Court also stated that the provision demonstrated "awareness of the problem" and a decision to "address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority." *Ibid.*

2. The Resolution did not establish United States policy because even though it was the "work product of an international organization of which the United States is a member; it has not been specifically endorsed, let alone signed, entered into, agreed upon, approved, or passed by either the Executive or Legislative Branch of the Federal Government." *Id.* at 11.

3. The 70 bilateral agreements explicitly "commit[ted] the United States to refrain from imposing national taxes on aviation fuel" but in none of the "agreements has the United States agreed to deny the States the power" to tax. *Ibid.* This omission was interpreted by the Court as "a policy choice by the contracting parties, especially in light of the . . .

[1] The bilateral agreements involved were Executive Agreements and did not qualify as treaties. Therefore, the agreements were not subject to the advice and consent of the United States Senate.

Resolution." *Ibid.* Finally, the Court found that the "course of conduct suggests that the parties to the Agreement and those most immediately affected by it understood it to permit this sort of taxation." *Id.* at 12.

Applying *Wardair*, United States policy will be determined by considering the following factors:

1. Awareness of a problem and a decision to address the problem by curtailing some elements of authority while implicitly preserving other elements of that authority. *Id.* at 10.

2. The adoption of a policy at the national level, while excluding subnational jurisdictions from the policy. *Id.* at 11.

3. A course of conduct suggesting that the taxation involved was understood and permitted. *Id.* at 12.

Applying these evidentiary factors to Legislative and Executive Branch actions establishes that it is federal policy to permit the States to use WWCR.

A. The Actions Of Congress Are Evidence Of A Policy Of The Federal Government To Permit The State Taxes Here At Issue

1. Congressional hearings prior to the consideration of the United States/United Kingdom Tax Convention

Prior to the United States/United Kingdom Income Tax Convention, Congress studied and considered the States' use of WWCR and took no action. The Court's decision in

Northwestern States Portland Cement Company v. Minnesota and *Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959), prompted Congress to quickly enact Public Law 86-272. Public Law 86-272 established a minimum jurisdictional standard for the imposition of State income taxes and "initiated a comprehensive study of all matters pertaining to the taxation of income derived from interstate commerce. . . ." *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th Cong., 2d Sess. (1964), Vol. 1, p. 8.

The Subcommittee, chaired by Representative Willis, conducted its study and hearings over several years. The results of this study are contained in five separate volumes and total over 2,600 pages of text and appendices. *State Income Taxation of Mercantile and Manufacturing Corporations: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary House of Representatives*, 86th and 87th Cong. (1961-1962) and *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1-4. Two of the issues considered by the Subcommittee are whether States should be allowed to use combined reporting and whether States should be able to consider income and activities reported as being outside of the United States. No legislation was enacted as a result of these hearings, study, or report.

Additional hearings on specific bills were held by the same Subcommittee in 1966. *Interstate Taxation Act, H.R.*

11798 and Companion Bills: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee of the Judiciary, House of Representatives, 89th Cong., 2d Sess. (1966). The reports of these hearings total over 1,800 pages. The subject matter of these bills was State tax practices with regard to interstate and foreign businesses, limitations on State use of combined reporting, and inclusion of the income and activities of foreign incorporated entities. None of these bills were enacted.

Similar hearings were held in 1973, *State Taxation of Interstate Commerce: Hearings before the Subcommittee on State Taxation of Interstate Commerce of the Committee on Finance, United States Senate*, 93rd Cong., 1st Sess. (1973).

The extensive studies undertaken by House and Senate committees demonstrate an awareness of the problems associated with the States' use of WWCR. The only action taken by Congress with respect to these concerns was the passage of Public Law 86-272. Because Congress did not adopt any other legislation, despite years of direct consideration of the "problems," Congress implicitly preserved other aspects of State tax authority.

2. Senate Consideration of the United States/United Kingdom Income Tax Convention

In 1975, the Executive Branch concluded discussions with the United Kingdom on a renegotiation of the bilateral Income Tax Convention. The revisions to the Treaty included a provision, proposed Article 9(4), which would have applied to subnational taxation. Proposed Article 9(4) would have prevented States from considering the results and activities of entities organized outside of the United States which were

owned and controlled by United Kingdom organized corporations.

In the Senate Committee on Foreign Relations Hearings on the United States/United Kingdom Tax Treaty held in July of 1977, one of the principal items of focus was the proposed Article 9(4). *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings before the Senate Committee on Foreign Relations*, 96th Cong., 1st Sess. (1977). Stip. ¶ 37c, BJA-24.[2]

In June of 1978, the proposed United States/United Kingdom Tax Convention (US/UK Tax Convention) was presented to the Senate for its advice and consent. During the debate on the proposed treaty, Senator Frank Church presented a reservation, the Church reservation,[3] to the treaty which would revise the provisions of proposed Article 9(4) so that it would not apply to State taxes and would not prohibit the States from using WWCR. The Senate debated the issue of whether this reservation should be attached to the treaty with respect to Article 9(4) and whether the Senate should give its advice and consent to the Convention with Article 9(4) as proposed on June 22 and June 23, 1978. Ex. 36C, BJA-238 and Ex. 36D, BJA-311.

On June 23, 1978, the Senate voted on whether it should give its advice and consent to the Convention with Article 9(4) as proposed by the Executive Branch. The recorded vote was 49 yeas and 32 nays.[4] Ex. 36D, BJA-311 at 393-394. The

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[2] References to BJA are to the Joint Appendix in *Barclays*.

[3] So named because its sponsor was Senator Frank Church of Idaho.

[4] Senator Muskie, who was present and had voted against the treaty, withdrew his vote because Senators Bentsen and Long were not present but

(continued...)

Senate is required to give its advice and consent to a treaty by a vote of two-thirds of the members present. (U.S. Const., art. II, § 2, cl. 2.) The Senate had thus refused to give its advice and consent and the treaty with proposed Article 9(4) was not ratified.

On June 27, 1978, the Senate again voted on whether to give its advice and consent to the proposed United States/United Kingdom Tax Convention, this time with the Church reservation included. The Senate's advice and consent was then given by a vote of 82 yeas and 5 nays. Ex. 36D, BJA-311 at 409-410.

These actions, when analyzed in relation to the factors considered in *Wardair*, clearly evidence a federal policy to allow the States to apply WWCR.

The history of the consideration of the US/UK Tax Convention demonstrates an acute awareness of the "problem." The Senate, by declining to give its advice and consent to the treaty, dealt with one element of the "problem" by restricting the use of WWCR for national taxation and remained silent as to the other element, subnational taxation. It dealt with the entire "problem" in unequivocal terms.

The second *Wardair* factor considers adoption of a national policy without concurrent adoption of a subnational policy. Except as to discrimination, all United States Income Tax Conventions are limited in their coverage to national taxes. See for example, Article 2, "Taxes Covered." United

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[4](...continued)
would have voted aye. Additional votes which were announced for absent members would have increased the final vote to 54 yeas and 34 nays. Ex. 36D, BJA-311 at 392-394.

States/United Kingdom Tax Convention, Ex. 40GG, BJA-444 at 445 et seq. In the circumstance of the US/UK Tax Convention, the question of whether subnational taxes should be accorded national treatment was presented and rejected by the U.S. Senate.

The Senate's consideration of the US/UK Tax Convention satisfies the *Wardair* factors. The Senate's course of conduct conclusively established that the Senate, and all other parties involved, understood and permitted the use of WWCR.

3. Senate Consideration of the Third Protocol to the United States/United Kingdom Tax Convention

As a result of the Senate's action in attaching the Church reservation to the proposed US/UK Tax Convention, the treaty was resubmitted to the United Kingdom. Before the treaty was approved by the United Kingdom, additional negotiations took place resulting in the Third Protocol to the Treaty. Along with other changes, the Third Protocol recognized the Church reservation. For further discussion see B.2., *infra*.

The Senate gave its advice and consent to the Third Protocol by a vote of 98 yeas and 0 nays. Ex. 36B, BJA-193 at 228.

The federal policy to allow WWCR is reinforced by the actions of the United States and the United Kingdom on the Third Protocol. The course of conduct of both countries indicates an understanding that the policy of the United States was to allow the States to use WWCR. These actions demonstrate awareness of the "problem" and the decision to curtail, at most, federal use of the WWCR method and not to curtail subnational use.

4. Congressional hearings subsequent to the negotiation of the United States/United Kingdom Tax Convention

The existence of federal policy is further established by Congressional activities contemporaneous with and subsequent to the US/UK Tax Convention. Despite numerous legislative proposals concerning WWCR, Congress refused to enact any prohibitions on the States' use of it.[5] In 1977 and 1978, while the Senate was considering the US/UK Tax Treaty, hearings were held on federal regulation of State income taxation of interstate and foreign commerce. *Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary*, 95th Cong., 1st and 2d Sess. (1977-1978). Stip. ¶ 37g, BJA-24.

In 1980, the Senate Finance Committee held hearings on S. 983 and S. 1688. The primary purpose of these bills was to prohibit State use of WWCR. *State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. (1980). Stip. ¶ 37e, BJA-24.

Again in 1986, a Subcommittee of the Senate Finance Committee held hearings on S. 1113 and S. 1974, bills which were specifically introduced to limit the States' ability to use WWCR. *Hearing before the Subcommittee on Taxation and*

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[5] A list of some of the bills which have been introduced in Congress which would have affected the States' use of worldwide combined reporting is set forth at ¶ 38 of the Barclays Joint Stipulation, BJA-24. None of these bills has been enacted. A list of the hearings which have been held by various Committees of Congress is set forth at ¶ 37 of the Barclays Joint Stipulation, BJA-23.

Debt Management of the Congress on Finance on S. 1113 and S. 1974, 99th Cong., 2d Sess. (September 29, 1986). Second Stip. ¶ 37i, BJA-47.

This course of conduct indicates Congress was aware of the States' use of WWCR and acquiesced in its use.

B. The Actions Of The Executive Branch Are Evidence Of A Policy Of The Federal Government To Permit The State Taxes Here At Issue

The bilateral tax agreements establish a federal policy permitting states' use of WWCR. A consistent federal policy is also evidenced by the conduct of the Executive Branch when negotiating income tax conventions with foreign countries. These treaties show that all parties were aware of the concerns surrounding WWCR and understood that federal policy was to restrict only national, and not subnational, use of WWCR.

1. The positions of the Executive Branch in negotiating bilateral tax treaties are evidence of the policy of the United States

In 1977 the Executive Branch published a Model United States Income Tax Treaty. Ex. 45, BJA-560. It revised this document in 1981. Stip. ¶ 45, BJA-37. In the statement of taxes covered, the treaty excludes subnational taxes. In June of 1979 at the *Hearing Before the Committee on Foreign Relations of the United States Senate on Six International Tax Treaties and Protocols*, in response to a question by Senator Church, Assistant Secretary of Treasury for Tax Policy, Donald C. Lubick, explained why State taxes were not included:

> "These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes." Ex. 37H, BJA-436 at 438.

In transmitting the Income Tax Convention with the Union of Soviet Socialist Republics to the Senate Foreign Relations Committee, the State Department made a similar statement regarding "Taxes Covered" in the Technical Explanation:

> "The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, *in keeping with past U.S. policy the taxes of the state and local governments of the United States* are excluded from the scope of the Convention, except for purposes of Article X (Nondiscrimination)." (Emphasis added.) Second Stip. ¶ 60, BJA at 49, Ex. 60, p. 18.

The long debate concerning the US/UK Tax Convention further evidences that United States policy permits WWCR. In transmitting the proposed treaty to the Senate for its advice and consent, the Executive Branch noted, "A second new provision is found in paragraph 4 of Article 9 (Associated Enterprises). This provision represents the first attempt to bind State and local taxing authorities by a substantive provision of the treaty (other than non-discrimination)." (Emphasis added.) Letter of Submittal, June 8, 1976, 3 Tax Treaties (CCH) ¶10,938.

After the United States Senate had approved the proposed treaty, with the Church reservation, members of the Executive

Branch negotiated the Third Protocol to the Treaty to reflect the action of the Senate. According to Treasury, one of the changes made to the treaty by the Third Protocol related to the North Sea permanent establishment rules. The British viewed the North Sea change as a concession by the United States in exchange for British acceptance of the United States reservation on Article 9(4). Reply of Donald C. Lubick to question posed by Senator Church, Ex. 37H, BJA-436 at 437.

Other members of the international community subsequently understood that United States policy did not prohibit the States' use of WWCR. In 1978, George S. Vest, Assistant Secretary of State for European Affairs, and Francois de Laboulaye, Ambassador of France, set forth the position of their respective governments on including a treaty prohibition on the States' use of WWCR as follows:

> It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject. Ex. 43, BJA-480 at 481-482.

In addition, Donald C. Lubick of the Department of the Treasury, in a letter dated April 22, 1980, advised Barber B. Conable, Jr. of the House of Representatives, with respect to the French Treaty:

> The unitary apportionment issue was discussed at length during the negotiation of the recent Protocol to the U.S.-French income tax Convention. The French negotiators accepted the fact that, on the basis of our experience with the U.K. treaty, the Treasury was unable to achieve ratification of a Protocol limiting unitary apportionment. Ex. 46C, BJA-568 at 570.

Further, in 1980, Allan J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada, and G. William Miller, Secretary of Treasury of the United States, exchanged notes concerning Canada's desire for a limitation on the States' use of WWCR. The note of G. William Miller stated in part:

> It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of the United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject. Ex. 42, BJA-477 at 478.

There is no confusion in the international community and the Executive Branch about United States policy. That policy permits States to use WWCR.

2. The statements of the Executive Branch on proposed federal legislation, introduced after this Court's decision in *Container*, to prohibit State use of WWCR is evidence of the Executive's recognition of accepted United States policy

Subsequent to this Court's decision in *Container*, the Executive Branch initiated efforts in 1985 to obtain passage of federal legislation which would "[e]ffect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ('the water's edge of requirement')." Ex. 36A, BJA-191. As way of explanation, President Reagan stated, "We hoped that by this time these principles would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law . . ." Ex. 36A, BJA-191.

The Executive Branch recognized: 1) the law did not require the States to forgo the use of WWCR and 2) the need to accomplish the desired change by the action of the Congress. This is not evidence of a United States policy against the States' use of WWCR, but rather evidence of an aspiration that United States policy be changed.

In September of 1986, the bill the President requested, S. 1974, came to a hearing. At the Hearing Before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on S. 1113 and S. 1974, Roger Mentz, Assistant Secretary (Tax Policy) Department of Treasury, testified as follows:

In general, S.1974 would prohibit states from levying corporate income taxes on a worldwide unitary basis, . . .

I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the successful operation of the Federal system. (Emphasis added.) . . .

We have not, however, reached the end of the road with respect to this issue. . . . We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time. Ex. 37I, BJA-440-441.

The Executive Branch was aware that the policy of the Federal Government permitted the States to use WWCR and that voluntary action was an appropriate and constitutionally permitted way to accommodate the needs of both the Federal Government and the States.

3. The Executive Branch's reservation to the model tax conventions of the Organization for Economic Cooperation and Development (OECD) is evidence of the policy of the United States to permit the States to use WWCR

In *Wardair*, this Court considered the significance of the adoption by an international organization of a model agreement which would have treated national and subnational taxes in an identical manner. This Court held that the action of the international agency was of no evidentiary value in

determining whether there was a policy of the United States against the State tax at issue in *Wardair* because the United States had taken no action to endorse, adopt, or enact the policy.

In 1963, and again in 1977, the Committee of Fiscal Affairs to the Council of the OECD published a Model Double Tax Convention on Income and On Capital. Ex. 44, BJA-484-559. The Executive Branch of the United States announced its reservation to that portion of the Model Treaty which made it applicable to subnational taxes. Ex. 44, BJA-484 at 501. This expressed reservation is evidence of federal law as it existed.

Under the *Wardair* analysis, the OECD Model Treaty cannot establish a United States policy prohibiting the State tax at issue because the United States did not endorse, adopt, or enact the policy. To the contrary, the Executive Branch's announcement of a reservation to the OECD Model Treaty evidences the United States policy not to restrict subnational taxation and, therefore, to permit the States to use WWCR.

CONCLUSION

The actions of both the Executive Branch and the Legislative Branch of the Federal Government provide clear and convincing evidence that the United States' policy is to permit the States to use WWCR. In many respects, the evidence present in these cases is more compelling than that relied upon by this Court in *Wardair*.

Use of WWCR by California and the other States is constitutionally permissible and the judgments of the California courts should be affirmed.

Dated: January 19, 1994

Respectfully submitted,

M.K. Heidi Heitkamp
North Dakota Attorney General
Counsel of Record
Office of the Attorney General
State Capitol
600 E. Boulevard
Bismarck, ND 58505
Attorney for Amici

Of Counsel:

Donnita A. Wald
Assistant Attorney General
State Tax Department
State Capitol
600 E. Boulevard
Bismarck, ND 58505

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QUESTIONS PRESENTED

Whether the Court should change the foreign policy of the United States with respect to State taxes after the Legislative and Executive Branches have refused to and, if so,

Whether the Commerce Clause requires a State to use a different accounting system to allocate profits for foreign corporations than it does for domestic corporations when Congress has refused for over thirty years to require such action?

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Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF CONGRESSMEN DON EDWARDS, HOWARD L. BERMAN AND XAVIER BECERRA AS AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

INTEREST OF AMICI

Amici appear before the Court as individual Members of Congress whose service on the Committee on the Judiciary of

the House of Representatives has given them a unique understanding of the issues presented by these cases that will be useful to the Court.[1]

The Judiciary Committee has general jurisdiction over the protection of trade and commerce against unlawful restraints and monopolies, Rule X. 1.(m)(16), Rules of the House of Representatives, and specific jurisdiction over bills regulating the authority of States to impose taxes on interstate commerce. 105 Cong. Rec. H. 11317 (June 18, 1959). As members of the Committee of the House of Representatives with specific subject matter jurisdiction, amici have a direct and continuing interest in the subject matter of these cases. Any legislation to reverse or modify this Court's decision in these cases would be brought to the Committee for its consideration and action.

SUMMARY OF ARGUMENT

Questions regarding State taxation of interstate and foreign commerce under the Constitution have always been directed in the first instance to Congress. The circumstances of these cases demonstrate the wisdom of this Court's policy of deferring to the judgment of Congress in these matters.

The States' refusal to use the "arm's-length" accounting method for allocating multinational companies' income has been the subject of extended Congressional consideration for over thirty years, but no legislation has been passed. Indeed, the United States Senate rejected a treaty proposed by the United Kingdom that would have prohibited States from using unitary accounting methods for multinational corporations.

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[1] Amici submit this brief in support of Respondent with the consent of all parties. Written consents are on file with the Clerk of the Court.

The United Kingdom accepted that rejection after additional negotiations and concessions by the United States.

The political process has worked. Congress made an informed, conscious decision to allow the States to continue to use unitary accounting methods to allocate the income of multinational corporations. California exercised its discretion and decided to allow multinational corporations the choice of having the method applied to them effective January 1, 1988, Barclays Joint Appendix (BJA), Ex. 55, BJA-696, subsequently modified in 1993 by Senate Bill 671 (Cal. Stats. 1991, Ch. 881). See Respondent's Supplemental Brief in Opposition to Petition, Appendix A.

There is no constitutional justification for this Court to second guess the political process of the States and Congress and give Barclays special treatment just because it is a foreign corporation or give Colgate special treatment just because it conducts part of its business in foreign countries. The tax prerogatives of the States are determined by the elected officials in the States and the United States Congress after due deliberation; they should not be dictated by the wishes of corporate taxpayers or of foreign governments seeking to gain a competitive advantage for their own companies, which have the ability to shift massive amounts of profit abroad.

ARGUMENT

INTRODUCTION

The paramount question in these cases is whether a State is required by the Commerce Clause to use a different, and easier to evade, accounting standard to allocate profits for foreign corporations than it does for domestic corporations. Subsumed within this question is the more fundamental

question of how to strike a balance between State and national sovereignty under our federal system. The other issues raised by the parties involving the treaty power, foreign affairs, and supremacy are all derivative of the Commerce Clause question.

The requirements of the Commerce Clause and the subsidiary questions must be answered by reference to the Constitution, not by the demands of foreign nations seeking favored treatment for their corporations. The Constitution provides directions for the division of several specifically identified responsibilities and powers within a system of checks and balances.[2] In addition, as part of the Bill of Rights, the Tenth Amendment provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

This reservation of powers to the States is enforced through the structure of the federal government. "[T]he principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress." *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 550-551 (1985). Thus, the structure of Congress, consisting of two houses made up of representatives of the States, assures that the powers delegated to the federal

[2] The powers of the Legislative Branch, art. I, § 8, and Executive Branch, art. II, § 2, are described with some specificity. Limitations on the powers granted to the United States are enumerated, art. I, § 9, as are powers prohibited to the States, art. I, § 10.

government under the Constitution "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments." *Id.* at 551 (internal quotations omitted). The Senate, in particular, with two members from each State and a restriction on the ability to change this characteristic by amendment is "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an instrument for preserving that residuary sovereignty." *Id.* at 551-552 (internal quotations omitted).

In forming the federal government, the States agreed to cede a portion of their individual sovereign powers in order to enhance their collective power. Two of the principal motivating factors for the formation of the Union were: 1) the desire to conduct commerce, whether between themselves or with other nations, free of selfish impediments, and 2) the conduct of relations with foreign governments.

In furtherance of the first objective, Congress was given the power "[t]o regulate commerce, with foreign nations and among the several states. . . ." U.S. Const., art. I, § 8, cl. 3. To achieve the second of these objectives, the President was given "the power, . . . to make treaties. . ." art. II, § 2, cl. 2. The President's power, however was subject to the limitation that it could only be exercised "with the advice and consent of the Senate . . . provided two-thirds of the Senators present concur. . . ." *Id.* Thus, the structure of our federal government guarantees the States a voice in the establishment of both foreign and domestic policy through their representatives in Congress.

Maintaining this voice in the tax area is critical. Without the ability to raise revenue, a government loses the ability to provide the services for which it was formed. As a consequence, the States, in forming our Union, jealously guarded their revenue base. The Constitution directly limits State tax prerogatives only in the case of "imposts or duties on imports or exports," U.S. Const., art. I, § 10, cl. 2. There is no other specific prohibition on State taxation.

I. SINCE THE ISSUES IN THESE CASES HAVE BEEN INTENSIVELY CONSIDERED BY BOTH HOUSES OF THE CONGRESS, THIS COURT SHOULD ACCEPT THE JUDGMENT OF THE CONGRESS.

A. This Court Appropriately Defers To Congressional Consideration Of State Tax Issues Because They Involve Delicate Issues of Federalism.

In 1983, this Court decided that the taxes here at issue as applied to a domestic-based unitary business were constitutional under a Dormant Commerce Clause analysis. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). Since that time, the Congress has had numerous opportunities to change the result of that decision.[3] It has not done so. Indeed, recent efforts by the Administration to revise the federal "arm's-length" method to

[3] A list of some of the bills which have been introduced in Congress which would have affected the States' use of worldwide combined reporting is set forth in Stip. ¶ 38, BJA-40. None of these bills has been enacted. A list of the hearings which have been held by various Committees of Congress is set forth in the Joint Stipulation at ¶ 37, BJA-23-24.

prevent multinational corporations from continuing to evade about $30 billion of federal taxes have not derailed public pressure to adopt a federal unitary method of taxing multinational corporations. *See,* Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes From Multinational Corporations*, Tax Notes, June 28, 1993, at 1841; John B. Judis, *Tax Brake, Clinton's Corporate Giveaway*, The New Republic, August 23, 1993, at 15.

Congress' repeated refusal to alter the result of *Container* should be respected by this Court. This Court should take the same position it took only eighteen months ago when it refused to overrule one of its prior decisions on a State tax, admittedly at odds with contemporary Commerce Clause jurisprudence. In part, this Court's reluctance was because Congress had the power to change the decision and was better equipped to balance the competing interests. *Quill Corporation v. North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91 (1992).

If this Court takes its own counsel as set forth in *Quill*, it will respect the judgment of the Congress and sustain the taxes in dispute. California has amended its tax code to relieve the concerns of foreign governments. If any additional action is required, Congress has the power and a more appropriate institutional perspective than this Court to strike the necessary balance between the rights of the States and the concerns of foreign governments.

In order to preserve the delicate balance of our federal system, this Court has generally required "clear and manifest" affirmative action by Congress before it strikes down a non-discriminatory State law. *Puerto Rico Dept. of Consumer*

Affairs v. Isla Petroleum Corp., 485 U.S. 495, 500 (1988). For example, this Court sustained a State tax that differed from the federal tax, even when Congress thought State law would follow federal law, because Congress did not *require* States to follow federal law. *Amerada Hess Corp. v. New Jersey*, 490 U.S. 66, 70 (1989).

Indeed, this Court has upheld State taxes even when it apparently questioned the wisdom of the tax. For example, in 1981, this Court reviewed a severance tax imposed by the State of Montana on the mining of coal. The tax was imposed at the height of the energy crisis and was vociferously opposed by residents of less energy blessed states who used Montana's coal. This Court found the tax permissible under the Commerce Clause. "Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress when particular state taxes are thought to be contrary to federal interests." *Commonwealth Edison Company v. Montana*, 453 U.S. 609, 628 (1981).

As Justice White stated in his concurrence:

> . . . Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. . . . Yet, Congress is so far content to let the matter rest, and we are counseled by the Executive Branch through the Solicitor General not to overturn the Montana tax as inconsistent with either the Commerce Clause or federal statutory policy in the field of energy or otherwise. The constitutional authority and the machinery to thwart the efforts such as those of Montana, if thought unacceptable, are available to Congress, and surely Montana and other similarly situated States do not have the political power to impose their will on the rest of the country. . . . the better part of both wisdom and valor is to respect the judgment of the other branches of the Government. 453 U.S. at 637-638.

If anything, under the reasoning of this Court in *Commonwealth Edison*, even greater deference should be given to State income taxes because the interests of the taxpayers have almost certainly been considered by the elected officials. In *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980), this Court recognized the special character of income taxation:

> Concurrent federal and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income. . . . Legislative proposals have provoked debate over issues closely related to the present controversy [apportionment and taxation of dividend income]. . . . Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so. (Citations omitted.) 445 U.S. at 448-449.

This Court found this to be true even when a different unitary formula was used by a State:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding

national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interest of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions. *Moorman Manufacturing Company v. Bair*, 437 U.S. 267, 280 (1978).

This Court's judgment that issues involving State taxation and the Commerce Clause should be resolved under the Constitution by action of the Congress because it is better designed to balance the concerns of the States and the taxpayers is sound and should be respected. *See* Chapman, *Chadha, Garcia and the Dormant Commerce Clause Limitation on State Authority to Regulate*, 23 Urban Lawyer 163 (1991).

B. Over The Last Thirty Years Congress Has Consistently Refused To Pass Legislation Limiting The States' Power To Use The Unitary Method Of Allocating Income For Multinational Companies.

There is no question that the issues raised in these cases have been exhaustively reviewed by Congress. Every effort to prohibit the State taxes at issue has been rejected.

Shortly after the Court's decision in *Northwestern States Portland Cement Company v. Minnesota and Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959),

Congress enacted Pub. L. No. 86-272 which, among other things, "initiated a comprehensive study of all matters pertaining to the taxation of income derived from interstate commerce. . ." *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1, p. 8.

The Judiciary Committee of the House of Representatives formed a special Subcommittee to study the issues presented by State taxation of corporate income. The Subcommittee conducted its study and hearings over several years. The results of this study are contained in five separate volumes and total over 2,600 pages of text and appendices. *State Income Taxation of Mercantile and Manufacturing Corporations: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary House of Representatives*, 86th and 87th Cong., (1961-1962) and *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1-4. Two of the issues considered in these volumes are whether States should be able to use combined reporting unitary accounting and whether States should be able to consider income and activities outside of the United States in computing State taxes on multinational corporations. These are the issues presented by these cases. No legislation was enacted as a result of these hearings, study and report.

Additional hearings were held by the same Subcommittee in 1966 which resulted in an 1,800 page report. *Interstate*

Taxation Act, H.R. 11798 and Companion Bills: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee of the Judiciary, House of Representatives, 89th Cong., 2d Sess. (1966). Not one of the bills to limit unitary taxation of foreign corporations was enacted.

Similar hearings were held in 1973. *Hearings before the Subcommittee on State Taxation of Interstate Commerce of the Committee on Finance, United States Senate*, 93rd Cong., 1st Sess. (1973).

In 1977 and 1978, hearings were held with respect to federal regulation of state income taxation of interstate and foreign commerce. *Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary*, 95th Cong., 1st and 2d Sess. (1977-1978). Stip. ¶ 37G, BJA-24.[4]

In 1980, the Senate Finance Committee held hearings on an Interstate Tax Bill, the primary purpose of which was to prohibit State use of worldwide combined reporting (WWCR) the unitary accounting method at issue in these cases. *State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. (1980). Stip. ¶ 37E, BJA-24.

[4] The hearings in 1977-78 are of particular significance because they occurred at the time the United States Senate was considering whether it would give its advice and consent to the United States/United Kingdom Income Tax Convention with its restriction on State consideration of the activities of United Kingdom-based businesses to determine the income earned within the State. *See infra*, at pp. 14-19.

Also in 1980, the House of Representatives' Committee on Ways and Means held hearings on H.R. 5076,[5] the purpose of which was to prohibit the States' use of WWCR. No vote on the bill was even taken by the Committee.

In 1986, a Subcommittee of the Senate Finance Committee held hearings on S. 1113 and S. 1974, bills which were specifically introduced to limit the States' ability to use WWCR. These bills never even went to a Committee vote.

In *Commonwealth Edison Company v. Montana*, 453 U.S. 609 (1981), this Court pointed out that there had been Congressional consideration of the level of the Montana severance tax in both the 96th and 97th Congresses. 453 U.S. at 628, fn. 18. Contrast this with over thirty years of Congressional consideration of WWCR. If the consideration of six bills over two Congresses carries significance, then certainly importance should be attached to the consideration of over twenty bills during more than ten Congresses, Stip. ¶ 38, BJA-24-25, at least nine Congressional hearings, Stip. ¶ 37, BJA-23-24 and Second Stip. ¶ 37, BJA-47, and, as discussed below, the rejection of a treaty prohibition on the tax at issue.

Multinational corporations and foreign governments certainly know how to make their views known to Congress. *See*, Brooks Jackson, *Honest Graft*, Alfred A. Knopf, New York, 1988. Congress, however, has refused their entreaties, as should this Court.

[5] The report of those hearings is included in the record of this case. Stip. ¶ 37D, BJA-24.

C. Since The Senate Refused To Give Its Consent To A Treaty Prohibiting The Taxes At Issue Here, This Court Should Accept The Senate's Judgment.

In determining whether a State tax impinges on the federal government's ability to conduct foreign affairs, the affirmative action of the Senate in refusing to consent to a treaty with a prohibition on State unitary taxes should be dispositive. In establishing the treaty power, and in making it subject to the advice and consent of two-thirds of the Senate, the Framers had in mind the protection of the States against untoward encroachment on their sovereign powers by the federal government. Whether a State tax is a foreign policy concern of the United States is for Congress and the Executive to decide, not foreign governments.

In 1975, the United States and the United Kingdom concluded negotiations on revisions to the then-existing income tax treaty between the countries. One of the provisions included in the renegotiated treaty was a clause, Article 9(4), which would have limited the ability of the States to use WWCR on United Kingdom-based businesses such as Barclays. In submitting the treaty to the United States Senate for its advice and consent, the Executive Branch noted that this was the first treaty involving income taxation in which such a limitation on the States had been included. Letter of Submittal, June 8, 1976, 3 Tax Treaties Reporter (CCH) ¶10,938.

The proposed limitation on State (subnational) taxation contained in Article 9(4) was the subject of intense debate both within the Foreign Relations Committee and on the floor

of the United States Senate. Senator Frank Church attempted to attach a reservation to the treaty with respect to Article 9(4) both in Committee and on the Senate floor. One of his concerns was the use of the treaty process to circumvent Congressional consideration of an action which would affect commerce. See Ex. 36C, BJA-238, and 36D, BJA-311, generally, and especially BJA at 251-254. The efforts to attach a reservation failed.

However, when the treaty was presented to the Senate on June 28, 1978, for its advice and consent, the vote was 49 in favor and 32 against. The treaty failed to obtain the necessary consent of the United States Senate. 124 Cong. Rec. S. 18670 (June 23, 1978). The next day, the treaty, after the reservation of Article 9(4) was appended, passed the Senate by the constitutionally required two-thirds affirmative votes, 82 in favor and 5 against. 124 Cong. Rec. S. 19076 (June 27, 1978).

The treaty, as approved by the Senate, was returned to the Executive Branch, which transmitted it to the United Kingdom for its reconsideration. Because of the change in the treaty, the United Kingdom requested that negotiations be reopened. The United States agreed, and the additional negotiations gave rise to the Third Protocol to the Treaty which made additional concessions to the United Kingdom as the result of the Senate's reservation on Article 9(4).

The Third Protocol was considered by the United States Senate on July 9, 1979 and passed 98 in favor, to 0 against. 125 Cong. Rec. S. 17434 (July 9, 1979). Ex. 36B, BJA-193 at 227-229. The United Kingdom then approved the treaty as modified, and it became effective on March 24, 1980.

With a much weaker expression of intent by Congress, this Court ruled in *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986), that a State was not preempted from imposing a tax affecting foreign commerce. This Court in *Wardair* had before it: 1) a multilateral international convention which exhibited awareness of a similar state tax that was prohibited and silence with respect to the tax at issue, 2) a resolution of an international organization which would have prohibited the specific tax, and 3) bilateral agreements adopted after the resolution which committed the United States not to assert taxes at the national level similar to the State tax at issue but which were silent with respect to subnational taxes. This Court found that the second of these items, the Resolution, was of little relevance because it had not been endorsed or adopted by the federal government. The other two items, however, were found by this Court to establish that the State tax was expressly permitted. This Court said, "the Federal Government is entitled in its wisdom to act to permit the States varying degrees of regulatory authority. In our view, the facts presented by this case show that the Federal Government has affirmatively decided to permit the States to impose these . . . taxes. . . ." *Id.* at 12, and concluded that, "we never suggested . . . that the Foreign Commerce Clause *insists* that the Federal Government speak with any particular voice." (Emphasis in original.) *Id.* at 13.

The *Wardair* analysis compels the conclusion that the Senate's rejection of the proposed clause in the US/UK income tax treaty is an affirmative decision by the federal government to permit the State tax here at issue. There is no need to look to other bilateral agreements whose history is silent with respect to the relevant issue. There is no need to

look to the agreements of international organizations which suggest one thing and bilateral agreements which do something else *sub silentio*. All that is required is to look to the Senate's consideration and rejection of the proposed limitation on State tax prerogatives. This action does more than manifest permission by implication; it does it by action, action which was understood as permission both by the United States and the United Kingdom who were parties to the treaty, by the States and commercial enterprises who would have been affected by a prohibition, and by other countries as well.[6]

Congress is charged with the responsibility of regulating Commerce. The Senate, as one of the houses of Congress, bears this responsibility directly in considering legislation. It also performs this function when it is required to give its advice and consent to a treaty involving commercial relations with foreign countries. In considering the US/UK tax treaty, specifically Article 9(4), the Senate performed its role as guardian of State prerogatives.

> [T]he principal and basic limit on the federal commerce power is that inherent in all congressional action — the built-in restraints that our system provides through state participation in federal governmental action. The political process ensures that laws that unduly burden the States will not be promulgated. In the factual setting of these cases the internal safeguards of the political process have performed as intended. *Garcia*, 469 U.S. at 556.

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[6] See Ex. 42, BJA-477 and Ex. 43, BJA-480.

Barclays claims that the State tax here at issue fails what is commonly known as Dormant Foreign Commerce Clause analysis because it "prevent[s] this Nation from 'speaking with one voice' in regulating foreign commerce." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979). Alternatively, Barclays claims that California's tax is invalid because it impinges upon the ability of the federal government to conduct the foreign affairs of the United States. The same analysis applies to both arguments, *Japan Line*, 441 U.S. at 449 (1979); *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), particularly when the President negotiates a treaty affecting the commercial relations of the United States.[7]

Barclays' reliance on *Japan Line* is misplaced. *Japan Line* deals with a property tax, not an income tax. In that case, the federal government, by treaty, recognized that the international movement of cargo vessels should not be impeded by State taxes and, thus, there was a need to "speak with one voice." The taxation of multinational corporations' income raises entirely different concerns because they have the ability to shift income among a complex web of subsidiaries carefully designed to evade taxes. This Court has recognized that protecting the tax status of vessels and containers is vastly different than granting constitutional protection to the accounting artifices created by the tax departments of multinational corporations. Compare *Japan Line* with

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[7] Because treaties often address commercial issues, the Constitution, art. II, § 2, cl. 2, provides that a treaty only becomes effective when two-thirds of the Senators present when it is considered give their advice and consent.

Container, which dealt with the same tax as is at issue in these cases and was decided four years later.

II. SINCE CONGRESS HAS DECIDED THAT THE STATES' USE OF THE UNITARY METHOD DOES NOT PREVENT THE GOVERNMENT FROM "SPEAKING WITH ONE VOICE," THIS COURT SHOULD NOT SUBSTITUTE ITS JUDGMENT FOR THAT OF CONGRESS

In *Container*, this Court recognized that the overlapping Commerce Clause and foreign affairs Constitutional questions are peculiarly political in nature. In making the "one voice" element part of its Commerce Clause analysis in *Container*, this Court recognized its institutional limitation in considering these issues:

> . . . In considering this issue, however, we are faced with a distinct problem. This Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please. 463 U.S. at 194.

This Court stressed that the "one voice" element was peculiarly an issue for the Executive and Legislative Branches:

> . . . the foreign policy of the United States — whose nuances, we must emphasize again, are much more the province of the Executive Branch and Congress than of this court. 463 U.S. at 196.

The "one voice" analysis involves determining whether a state tax will "impair federal uniformity in an area where federal uniformity is *essential*." (Emphasis added.) *Japan Line*, 441 U.S. at 448. In *Container*, this Court said that uniformity might be essential if the State tax "might *justifiably* lead to significant foreign retaliation." (Emphasis added.) 463 U.S. at 194. The facts of this case demonstrate that suppressing a State's right to choose its tax system is not essential to uniformity and the retaliation threatened by the United Kingdom was resolved by the political system.

In any event, once United States foreign policy has been made, suggesting that the Constitution requires it be changed in the face of foreign threats is a dangerous precedent. It would encourage threats and retaliatory legislation where none would have been considered.

A. Congress Has Decided That Identical Taxation Of Multinational Corporations By The States And Federal Government Is Not Essential For Our Country To Speak With "One Voice" In Foreign Policy.

This Court recognized in *Container* that the determination of whether uniformity in this area is *essential* is a decision which must be made in the first instance by the Executive and Legislative Branches, 463 U.S. at 194. Congress' refusal to pass any one of innumerable bills to prohibit the States' use of WWCR for almost thirty years evidences a conviction that uniformity in this area is not essential. If it were, Congress would have acted.

Circumstances have proved Congress to be correct. Foreign commerce continues. Residents of the United

Kingdom, the nation that has gone the furthest in threatening retaliation, continue to be among the single biggest investors in the United States[8] and in California.[9]

B. Threats Of Retaliation By Foreign Governments Should Be Handled By The Political System, Not This Court.

The United States' Income Tax Conventions, except with respect to non-discrimination, do not apply to taxes asserted by subnational jurisdictions such as States. *E.g.*, The United States Model Income Tax Treaty. Ex. 45, BJA-560. In presentations to international groups, representatives of the Treasury have stated that the United States will not include subnational taxes under treaties, with the exception of nondiscrimination, because the Senate will not approve it. See Ex. 37H, BJA-436 at 438.[10] Because these foreign governments have been unable to get the Executive and Congress to change the policy of the United States government, they are now asking this Court to change the policy of the United States as a matter of constitutional law.

Despite the additional benefits the United Kingdom got because it accepted the US/UK tax treaty without a prohibition on State taxation, it reneged on the deal and threatened to

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[8] *Foreign Direct Investment in the United States: An Update*, U.S. Dept. of Commerce (June 1993), p. 23.

[9] *Foreign Direct Investment in California*, State of California (Nov. 1993), pp. 4-5.

[10] Material is from a submission by the Department of Treasury to XIX Inter-American Center on Tax Administrators (CIAT) Technical Conference on "Exchange of Information Under Tax Treaties" August 28-September 3, 1977, Curacao. Ex. 37H. *International Tax Treaties: Hearing before the Senate Comm. on Foreign Relations*, 96th Cong., 1st Sess. (June 6, 1979), p. 111-112 (statement of Donald C. Lubick).

withdraw a benefit which the same treaty conferred upon United States corporations, Ex. 40GG, BJA-444 at 455-459, Article 10, because of the States' continued use of WWCR. The United Kingdom has now withdrawn the threat of retaliation, but holds it in reserve if it is displeased with California's implementation of its new "water's-edge" legislation or if another State should choose to adopt WWCR. *See* State Tax Notes, 93 STN 181-16 (September 20, 1993). This Court should not encourage the United Kingdom to hold hostage either United States foreign policy or United States internal policy regarding the powers of the States.

Perhaps one reason the United Kingdom threatened to breach the treaty is because unitary accounting undercuts the *raison d'etre* of British tax havens such as the Channel Islands, the British Virgin Islands, Gibraltar, Hong Kong and the Cayman Islands, which are used by offshore corporations to evade taxes under the "arm's-length" method of accounting. In fact, the Crown Colony of the Cayman Islands is now the fifth largest banking center in the world.

C. The Practical Effect Of Limiting Use Of The Unitary Method Will Be To Impair The Ability Of American Companies To Compete Against Foreign Companies.

Although the legal issue in the *Barclays* case is whether it is constitutional for a State to impose the same tax accounting requirements faced by domestic companies upon foreign multinational corporations, the real issue is whether foreign multinational corporations will be allowed to shift their tax burden onto domestic corporations as a matter of constitutional law. If Barclays prevails, domestic companies will be forced

to pay the taxes that the foreign companies will escape. Indeed, if Barclays prevails, our domestic companies will have to compete against foreign corporations which pay no income taxes whatsoever on their exports to the United States because in many countries there is no corporate income tax, only a Value Added Tax on products which is rebated to a corporation if it exports the product.

The "arm's-length" method used by the federal government essentially allows a corporation to use intra-company sales as a method of allocating income. For example, if a Japanese auto manufacturer sold a car to its U.S. distributor for $30,000, its U.S. distributor might sell it for $32,000. After deducting administrative and advertising costs for its U.S. subsidiary, the Japanese company could declare that it lost money on the sale in the U.S. even if it booked a $10,000 profit on that car in Japan when it sold it to its U.S. distributor.

Unfortunately, trying to police the "arm's-length" system is like trying to police the New Jersey turnpike on a bicycle. According to every former Commissioner of the Internal Revenue Service who testified before the Oversight Subcommittee of the House Ways and Means Committee, the IRS is totally outgunned by these corporations when it somehow discovers an egregious example of revenue shifting and tries, using the "arm's-length" method, to collect the taxes that should have been paid.[11] In an attempt to stop some of

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[11] *Tax Underpayment by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives*, 101st Cong., 2d Session, July 10 and 12, 1990, at 41.

(continued...)

the abuse, the IRS recently issued complex temporary regulations,[12] but so far all they appear to have generated are seminars in vacation spots for lawyers, accountants and economists eager to learn how to work the system for their clients and a spate of articles moaning about the onerous burdens being imposed by these new regulations.[13]

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[11](...continued)

In 1992, the Subcommittee revisited the 36 firms it studied in 1990 and found that these firms actually paid less taxes than reported originally. *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives*, 102d Cong., 2d Sess., April 9, 1992, at 5.

[12] 26 CFR §§ 1.481.1 through 1.483-2T, 58 Fed. Reg. 5263 (June 21, 1993).

[13] Witnesses Say Transfer Pricing Penalty Regs are Too Restrictive, Tax Notes, May 24, 1993, p. 1005; Panels Ponder Foreign Tax Issues, Tax Notes, May 17, 1993, p. 877; William L. Raby, CPA, Section 482 and the Under $10-Million Corporation, Tax Notes, March 22, 1993, p. 1637; James P. Fuller and Ernest J. Aud, Jr., The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?, Tax Notes, March 15, 1993, p. 1517; Transfer Pricing Regs Don't Require Proving a Negative, Official Says, Tax Notes, March 15, 1993, p. 1413; Burgess J. Raby and William L. Raby, Section 482 Reasonable Cause Proposal Not Reasonable, Tax Notes, March 8, 1993, p. 1347; Kellogg Management School Conducts Conference on Transfer Price Regs, Tax Notes, February 22, 1993, p. 1015; John Simpson et al., From "CPI or Die" to the Best Method Rule: An Economic Analysis of the Arm's Length Standard Under the New IRS Regulations for Intercompany Pricing, Tax Notes, February 22, 1993, p. 1089; Steven P. Hannes, Esq., An Evaluation of IRS's 1993 Transfer Pricing and Related Penalty Proposals: Round Three, Tax Notes, February 15, 1993, p. 933; Treasury's Mogle Offers Insights on New Transfer Pricing Regs, Tax Notes, February 8, 1993, p. 683; George N. Carlson, et al., Deja Vu All Over Again: The New Section 482 Regulations, Tax Notes, February 1, 1993, p. 607; IRS Releases Temporary Transfer Pricing Regs, Tax Notes, January 18, 1993, p. 287.

Under these circumstances, it is hopelessly naive to believe that profit-maximizing corporations, making any kind of a cost-benefit calculation, will not structure their accounting to minimize taxes. Given a vague standard and ineffectual enforcement, it would be inconceivable not to expect managers to do all they can to shift revenue to the lowest tax jurisdiction. The rewards weighed against the risks are simply too great. No public policy should be based on a notion that corporate managers are more virtuous or public spirited than the general run of mankind.

A June 1993 Commerce Department Report to Congress on Foreign Direct Investment in the United States estimated that one half of the taxes owed by foreign multinational corporations were evaded by transfer pricing abuses. By one estimate that is about $30 billion a year[14] — real money even in federal government terms. According to the IRS, in 1989, the last year for which data is available, 71.7% of foreign companies paid no U.S. taxes at all and, as a group, reported less than one third the taxable income of U.S. firms as a percentage of receipts (.9% v. 3.1%) despite the fact that their

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[14] A study by Professor James A. Wheeler summarized in Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes from Multinational Corporations*, Tax Notes, June 28, 1993, at 1842. *See also* a study by Professors Pak and Zdanowicz reported in Tax Analysts Highlights & Documents, January 11, 1994, at 11, which estimated that "Foreign-held firms used transfer pricing shenanigans to dodge an estimated $28 billion or more in federal income taxes in 1992. . . ." They "found that trade with Japan accounted for an estimated 13 percent of lost U.S. income tax revenues, or more than $4 billion annually. Other countries with "abnormalities" exceeding $1 billion were: Germany ($3.1 billion); Britain ($2.5 billion); Canada ($2.1 billion); France ($1.6 billion); Mexico and Taiwan ($1.4 billion); the Netherlands ($1.3 billion); and Brazil ($1.1 billion)."

assets went up three times as fast as domestic companies. Apparently, they are losing money on every sale, but making it up in volume!

Because these foreign corporations failed to get Congress to prohibit State use of unitary tax systems that this Court has consistently recognized as at least as accurate a method as the "arm's-length" method of allocating income, *Allied-Signal v. Dir. Div. of Taxation*, 504 U.S. ___, 119 L.Ed.2d. 533 (1992), they are now asking this Court to prohibit State use of unitary tax systems against foreign multinational corporations on constitutional grounds. They argue that unitary tax systems are too burdensome to apply and violate international standards. The first point doesn't even pass the smile test: How can the management of a corporation suggest with a straight face that it does not know where its sales, personnel and property (the usual factors in unitary accounting systems) are located? On the second point, the one time such a prohibition was included in a treaty, the Senate refused to pass the treaty until the prohibition was removed.

The only consistent theme in the multinationals' argument against the unitary method of allocating income or against making the "arm's-length" method more effective is that they don't want to pay taxes. Nor do most taxpayers, but most recognize that payment of taxes (even when there is disagreement with their expenditure) is the price of a civilized society.

CONCLUSION

Since (1) Congress has refused for over thirty years to pass legislation prohibiting States from using the unitary method for allocating the income of multinational corporations

and, in fact, the one time it was faced directly with the issue, refused to consent to a treaty which contained such a prohibition, and (2) this Court has consistently recognized that the unitary method is as well accepted and at least as accurate a method as the "arm's-length" method of allocating income, this Court has no basis to find that the States' use of the unitary method violates the Constitution.

The decisions of the California Courts in these cases should be affirmed.

Dated: January 19, 1994

Respectfully submitted,

Martin Lobel
Counsel of Record
Jack A. Blum
Dina R. Lassow
Lobel, Novins, Lamont & Flug
1275 K Street, N.W., Suite 770
Washington, D.C. 20005
(202) 371-6626
Attorneys for Amici Curiae

(D) (A)

Nos. 92-1304 and 92-1839

JAN 19 1994

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In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF AMICI CURIAE BY THE STATE OF NEW MEXICO AND THE STATES OF ARKANSAS, COLORADO, IDAHO, MAINE AND RHODE ISLAND IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

BRUCE J. FORT
FRANK D. KATZ
Sp. Asst. Attys. General
Taxation & Revenue Dept.
P. O. Box 630
Santa Fe, NM 87509

TOM UDALL
New Mexico Attorney General
DANIEL YOHALEM
Counsel of Record
Asst. Atty. General
P. O. Drawer 1508
Santa Fe, NM 87504
(505) 827-6070

(Continued on inside cover)

BEST AVAILABLE COPY

WINSTON BRYANT
Attorney General
323 Center Street, Suite 200
Little Rock, Arkansas 72201-2610

(MS.) GALE A. NORTON
Attorney General
State of Colorado
1525 Sherman Street, Fifth Floor
Denver, Colorado 80203

LARRY ECHOHAWK
Attorney General of Idaho
Room 210, State House
Boise, Idaho 83720

MICHAEL E. CARPENTER
Attorney General
State of Maine
State House, Section 6
Augusta, Maine 04333

JEFFREY B. PINE
Attorney General
State of Rhode Island
72 Pine Street
Providence, Rhode Island 02903

QUESTION PRESENTED

Whether worldwide combined reporting may be constitutional applied to foreign-based and domestic-based unitary business enterprises under this Court's dormant Commerce Clause analysis?

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Nos. 92-1384 and 92-1839

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF AMICI CURIAE BY THE STATE OF NEW MEXICO AND THE STATES OF ARKANSAS, COLORADO, IDAHO, MAINE AND RHODE ISLAND IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

INTEREST OF AMICI CURIAE

Amici are States which compute the individual tax liabilities of multijurisdictional business under the "unitary

business principle." Amici have a direct interest in the application of this Court's dormant Commerce Clause analysis to the question of what foreign source income of domestic corporate taxpayers can be considered in determining the amount of income which can be properly included in the taxpayer's apportionable tax base. This interest becomes greater each year with the continuing internationalization of the United States economy and the economy of each of the States. All of the Amici States, like California, employ accounting practices based on the formulary apportionment principle embodied in the Uniform Division of Income for Tax Purposes Act (UDITPA), 7A Uniform Laws Annotated 331 (West 1985). Many of these States include in their determination of a corporation's apportionable income interest, royalties, dividends and similar payments from that corporation's foreign subsidiaries ("foreign source" income). Taxpayers in a number of States have challenged the inclusion of this income in the apportionable bases, on the theory that the income, or the income payor, may have been subject to taxation by foreign jurisdictions under arm's-length accounting principles. *See, e.g., NCR Corporation v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989), *cert. denied*, 493 U.S. 848 (1989); *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico*, 856 P.2d 982 (N.M.Ct.App.1993), *cert. pending*, S.Ct. No. 93-541.

In 1983, this Court rendered a milestone decision in the area of state corporate income taxation in the case of *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). The *Container* decision settled the jurisprudence in this area. This Court's acceptance of the petitions by Barclays and Colgate has drawn that decision into

question. A decision adverse to California in these cases would likely unsettle what are now viewed as resolved issues. Reversal of *Container* will have significant ramifications for all states which will take several decades of litigation to sort out. Amici believe that the fundamental holding of *Container* — that "foreign-source" income of a unitary business may be included in the apportioned tax base — should be affirmed.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of Respondent Franchise Tax Board, State of California. Consent to the filing of this brief has not been requested from the parties because the Amici filing this brief are the Attorneys General of their respective States. Rule 37.5.

SUMMARY OF ARGUMENT

The actions of the Federal Government establish that the California tax at issue in these cases is constitutionally permitted without the need for a dormant Commerce Clause analysis. Amici, nonetheless, undertake such an analysis and show that under that analytical tool the tax also passes constitutional muster.

Dormant foreign Commerce Clause analysis has six distinct elements. In the circumstances of these cases, there is no question that the taxpayers are engaged in worldwide unitary businesses and that the application of the three-factor apportionment formula has resulted in a fair and proper tax being computed. It is apparently uncontested that the first

(nexus), second (fair apportionment), and fourth (fair relationship) elements are met.

With respect to the third element of dormant Commerce Clause analysis, discrimination, Amici argue that Petitioner Barclays' claims are not complaints of discrimination but demands that they be discriminated *in favor of* because of their foreign parentage and location. There is no basis for such a claim. Foreign-based businesses have a legitimate basis to claim equal treatment, but not to claim preferential treatment.

This Court's analysis in *Container* of the fifth element of dormant Commerce Clause analysis, multiple taxation, is applicable to both foreign-based and domestic-based businesses. In the field of income taxation, the risk of multiple taxation can only be eliminated by requiring a jurisdiction to forgo taxation completely. This solution is neither proper nor required.

The final element of dormant Commerce Clause analysis, "one voice," applies to invalidate a tax only when uniformity is essential and possible foreign retaliation is justified. Neither circumstance is present in these cases. Twenty years of discussions, negotiations and agreements with the United Kingdom establish this to be true.

The California tax remains, as this Court found it in *Container*, a "proper and fair tax" and should be sustained.

ARGUMENT

THE CALIFORNIA TAX AT ISSUE IN THESE CASES MEETS ALL THE REQUIREMENTS OF THIS COURT'S DORMANT COMMERCE CLAUSE ANALYSIS

A. Introduction

No treaty to which the United States is a party, and no statutory enactment of the United States, specifically prohibits the States from using the worldwide combined report (WWCR) accounting method with respect to either domestic-based or foreign-based corporations. To the contrary, there is compelling evidence which establishes the existence of a federal policy permitting the States to use WWCR. *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986). This policy can be drawn by implication from the body of federal law. Under these circumstances, a dormant Commerce Clause analysis is not required. Nonetheless, for purposes of argument only, Amici proceed on the premise that this Court may undertake a dormant Commerce Clause analysis to determine whether the California tax at issue in these two cases is constitutionally permissible.

The Constitution of the United States provides that the Congress shall have the power "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes;" Article I, Section 8, Clause 3. "The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued

relations among the Colonies and later among the States under the Articles of Confederation." *Hughes v. Oklahoma*, 441 U.S. 322 at 325 (1979). Recognition of this principle has given rise to the view that the Commerce Clause, in the absence of evidence of specific action taken by the Federal Government to regulate commerce, nevertheless contains self-executing constraints on state action. *H.P. Hood & Sons, Inc. v. DuMond*, 336 U.S. 525 (1949); *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945). In recognition of these self-executing constraints, this Court has developed a species of analysis commonly known as dormant Commerce Clause analysis.

The modern view of dormant Commerce Clause analysis with respect to interstate commerce was set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and was extended to foreign commerce, and expanded upon, in *Japan Line, Ltd v. County of Los Angeles*, 441 U.S. 434 (1979). As set forth in *Complete Auto* and *Japan Line*, the elements of a dormant Commerce Clause analysis with respect to foreign commerce are:

1) The tax must be applied to an activity with a substantial nexus with the taxing State, *Complete Auto*, 430 U.S. at 279,

2) The tax must be fairly apportioned, *Id.*,

3) The tax must not discriminate against interstate [or foreign] commerce, *Id.*,

4) The tax must be fairly related to the services provided by the State, *Id.*,

5) The tax must not give rise to an enhanced risk of multiple taxation, *Japan Line* 441 U.S. at 446, and

6) The tax must not impair federal uniformity in an area where federal uniformity is essential. *Id.* at 448.

The capstone decision applying this analysis to taxation of "foreign-source" income is *Container*.

Amici believe that the *Container* decision was correctly decided and controls with respect to the petition of the Colgate-Palmolive Company. Amici also believe that this Court's analysis of the dormant Commerce Clause requirements in *Container*, and in other cases, establishes that application of WWCR to a foreign controlled business is also constitutionally permissible. For purposes of this argument, Amici will apply the Court's dormant Commerce Clause analysis anew to Colgate and to Barclays.

B. The *Complete Auto Transit* Elements

1. Substantial Nexus

The unitary business principle is the linchpin which satisfies the requirements of nexus. *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Container*. This is true for both Due Process Clause and dormant Commerce Clause purposes.

Barclays Bank Limited (Barclays) was present in California in 1977 through a wholly owned subsidiary, Barclays Bank International Limited (BBI), Stip. ¶¶ 1 and 6, BJA-9-10[1], and through a wholly owned second-tier

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[1] The Joint Appendix in Barclays is referred to as BJA and the Joint Appendix in Colgate is referred to as CJA.

subsidiary, Barclays Bank of California (Barcal), Stip. ¶¶ 8 and 9, BJA-10-11. Barclays conducted a banking agency business in California, Stip. ¶ 1, BJA-9, and a commercial banking business in California, Stip. ¶ 9, BJA-11. For purposes of this litigation, BBI and Barcal agree that they were members of a worldwide unitary business, within the meaning of California law, conducted by Barclays, Stip. ¶ 27, BJA-16. The nexus element of dormant Commerce Clause analysis is satisfied.[2]

Colgate-Palmolive Company is a corporation organized and existing under the laws of Delaware, was headquartered in New York, and was qualified to do, and was doing, business in California. Stip. ¶ 1, CJA-4. Although at the trial level Colgate contested the Franchise Tax Board's determination that it was conducting a unitary business, it did not appeal the trial judge's adverse decision on this issue. Colgate is a unitary business. The nexus element of dormant Commerce Clause analysis is satisfied for Colgate as well.

2. Fairly Apportioned

In order to prove that the tax determined under an apportionment formula is unfair, the taxpayer must prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that state,' 283 U.S., at 135, [cites omitted] or has 'led to a grossly distorted result,' [Norfolk & Western R. Co. v. State Tax Comm'n, 390 U.S. 317, 326

[2] Barclays appears to raise the question of whether this issue was decided by the lower courts, Barclays' Brief for Petitioner (Br.Pet.) 13, fn. 6. It does not appear that this has been raised on appeal here, except by Amici Government of the United Kingdom, pp. 24-27.

(1968)]." *Moorman Mfg. Co. v. Iowa*, 437 U.S. 267, at 274 (1978).

In *Container*, this Court set forth a two-fold standard by which to determine fairness: "internal consistency — that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed" and "external consistency — the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container*, 463 U.S. at 169. The Court has used this tool to measure the fairness of a state tax in a number of subsequent cases. *Goldberg v. Sweet*, 488 U.S. 252 (1989);[3] *American Trucking Assn., Inc. v. Scheiner*, 483 U.S. 266 (1987); *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984).

California, during the years in issue, followed the UDITPA and used the three-factor apportionment formula contained in the Act for Colgate and used a modified three-factor apportionment formula for Barclays.[4] The use of the three-factor formula was approved by this Court in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), and is now referred to by the Court as "something of a benchmark against which other apportionment formulas are judged." *Container* 463 U.S. at 170, *Amerada Hess Corporation v. Division of*

[3] The definition of "external consistency" was worded differently in *Goldberg v. Sweet* where the Court phrased it as "ask[ing] whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed." 488 at 262. The difference in wording would appear to have no impact on these cases.

[4] The three-factor formula used by California for banks and financials includes intangible property in the measure of the property factor.

Taxation, 490 U.S. 66 at 73 (1989). UDITPA's apportionment formula is both internally and externally consistent.

During the course of the trial in this matter, counsel for Barclays advised the trial judge that Barclays was not arguing that the taxes were unfairly apportioned. BJA-832-833. The fair apportionment element of dormant Commerce Clause analysis is not at issue in that case.

At the trial level, Colgate argued that application of WWCR distorted the amount of income attributed to California. The trial judge found against Colgate on this issue, and the decision was sustained by the appellate court which held that Colgate had not met the steep burden of demonstrating an unconstitutional distortion of its liability determined through the use of WWCR and that the tax was fairly apportioned. Colgate Petition, Appendix E, pp. 66a-71a. Colgate did not contest the state court decision in its petition to this Court.

3. Discrimination

This Court has held that a tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce. *Amerada Hess* 490 U.S. at 75.

There is no discrimination on the face of the California statute and neither taxpayer claims that the statute on its face treats in-state and out-of-state businesses differently to the disadvantage of the out-of-state business. There is also no discriminatory intent manifested in the California law, and the taxpayers do not claim that the California tax was intended to give an advantage to local industry.

The only argument offered regarding discrimination is made by Barclays, which argues that the effect of the California tax is discriminatory because it creates undue, "prohibitive," burdens on foreign-based multinational businesses in order to file a California return using WWCR. Petitioner Colgate's argument is even simpler. It is the "What if?" argument. Colgate argues that if this Court were to find in favor of Barclays, regardless of the reason, it would then be discriminatory to tax Colgate under a different taxing scheme.

Stated in its simplest terms, Petitioner Barclays is requesting special treatment because they are foreign-based businesses which voluntarily entered the California market. The Constitution of the United States, the treaties entered into by the United States,[5] and the statutes of the United States do not require that foreign-based businesses be given dispensations so that they may operate at a competitive advantage as compared to United States-based businesses. *Sumitomo Shoji American, Inc. v. Avagliano*, 457 U.S. 176 (1982). A foreign-based business must pay its way, and it is reasonable for a tax authority to require a foreign corporation to present its tax information in a manner which complies with the requirements of the tax authority as long as they do not disadvantage the foreign entity. There is no credible evidence that California's filing requirements cause an undue burden on Barclays. California's rules regarding the preparation of combined reports involving worldwide activities are before

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[5] Barclays' counsel at trial stated that it was not claiming that it had been discriminated against in terms of the protections offered by the United States/United Kingdom Tax Convention. Reporter's Transcript (RT) 1815-1824, BJA-837-840.

this Court, Ex. 12, BJA 50-57, and, therefore, this Court should not be misled by the exaggerated and inaccurate claims made by Barclays and its amici.

First, under California law, it is not necessary for Barclays to set up a second and separate system of accounting. Barclays may use statements it regularly prepares for its own purposes with adjustments to these statements, *if material*, BJA-54, (b)(3)(C), to reconcile differences between foreign and United States GAAP and California tax accounting standards. See Regulation § 25137-6, BJA-50, (b)(A), and BJA-51, (b)(2). Moreover, Barclays had prepared United States GAAP statements for other purposes. Stip. ¶ 51 and Ex. 51G, BJA-40.

Second, Barclays does not have to maintain its records in United States dollars and in English. Regulation § 25137-6 provides that the calculation of income, BJA-51, (b)(1)(D) and (b)(2), and the apportionment factors, BJA-55, (c)(1)(E), and BJA-56, (c)(2)(C), are to be made in the currency of the parent company. In any event, the language in which the consolidated records of Barclays are maintained is English.

Third, Barclays presses the argument that hypothetical costs of compliance in the millions of dollars creates an undue burden and thereby establishes a basis for discrimination which they characterized as "economic protectionism." (Br.Pet. p. 44, fn. 13.) The California appellate court found that the real cost of compliance, as evidenced by the bills from a major accounting firm for preparing the WWCR returns filed by BBI, was $900 to $1,250 annually. Appendix to the Petition, D-19, fn. 9. These returns were acceptable to California except as to the scope of the unitary business. This

Court should defer to the judgment of the California courts as to what level of detail, specificity and documentation is sufficient for California tax filings. This is not the stuff of discrimination.

Fourth, foreign-based businesses do not file on a different basis under Regulation § 25137-6 than do domestic-based businesses, and therefore, the foreign-based businesses need not forgo tax benefits. Barclays' argument is based on the unfounded assumption that a domestic-based business maintains its records in a form which corresponds to the filing requirements of California. The reasons for a domestic-based corporation to maintain records which conform to the requirements of the California Revenue and Taxation Code are the same as they are for a foreign-based corporation: to file California tax returns. There is no other reason. To the extent a separate set of records or schedules is required for a domestic-based business, it is required for a foreign-based business. To the extent a domestic-based business can use estimates and approximations, a foreign-based business may. There is no discrimination. Barclays was treated in the same way every other taxpayer was treated. BJA-831-832.

Finally, Barclays wrongly claims discrimination because it must comply with WWCR in California but domestic-based businesses do not have to comply with WWCR in any foreign country. There is no evidence in the record as to what tax and information requirements domestic-based multinationals are subject to in foreign countries. Without that evidence, Barclays' claim is without support. More importantly, this argument is based on a faulty comparison. The relevant point of comparison for the purposes of the United States Constitution is what *California* requires of domestic-based

unitary businesses versus what it requires of foreign-based unitary businesses. It requires the same method of filing, WWCR, and the same information; therefore, there is no discrimination. In *Container*, this Court, held that the States' use of formulary apportionment need not yield to the arm's-length accounting methods favored overseas. 463 U.S. at 193.

In considering the discrimination arguments raised in these cases, this Court is presented with a blueprint of the consequences if it accepts them. First, Barclays claims discrimination because it is foreign. It advances a number of reasons why its place of organization justifies separate treatment. If this Court accepts Petitioner Barclays' argument, and concludes there is discrimination, then it must face a second claim of discrimination by domestic-based multinationals.

Petitioner Colgate is dependent upon Barclays winning its case. If Barclays does not win, then how can Colgate win? If Barclays is successful, then Colgate argues, as did the dissent in *Container*, 463 U.S. at 197-205, that it is being discriminated against vis-à-vis foreign-based multinationals. Colgate's argument, if accepted, requires that *Container* must be overruled.

The unraveling of the fabric of this Court's analysis continues when Colgate's logic is extended to the unitary business which conducts all or part of its foreign activities through a domestic corporation, or a unitary business which functions through a single corporation, foreign or domestic. Colgate's preferential treatment in these circumstances will again open the door for further claims of discrimination and

the overruling of a series of cases including *Bass, Ratcliff & Gretton, Ltd.*, 266 U.S. 271 (1924), and *Mobil Oil*, 445 U.S. 425. In fact, the consequences may ultimately lead to another revisitation of the unitary business principle as this Court did two terms ago in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. ___, 119 L.Ed.2d 533 (1992).

Any differences in compliance costs between domestic-based and foreign-based multinationals argued by Barclays and Colgate are purely hypothetical, not actual, and arise from an improper comparison of taxpayers who are not similarly situated. *Kraft General Foods v. Iowa Dept. of Revenue and Finance*, 504 U.S. ___, 120 L.Ed.2d 59, fn. 23 (1992). By characterizing these hypothetical differences as discrimination, Barclays invites this Court to take a first step on a slippery slope. Barclays has been treated in a nondiscriminatory manner, and the California tax should be affirmed. The question of compliance requirements for similarly situated taxpayers is appropriately left to the legislative branch of government, either state or national, so long as they are fairly applied, as they are here.

4. Fairly Related to Services Provided

The requirements of this element of dormant Commerce Clause analysis are satisfied by the provision of such state services as "police and fire protection, the benefit of a trained work force and 'the advantages of a civilized society.'" *Exxon Corporation v. Wisconsin*, 447 U.S. 207, at 228 (1980). There can be no doubt that both Barclays and Colgate enjoy these basic California benefits and neither petitioner has

presented any evidence with respect to this issue.[6] It is not properly before this Court.

C. The *Japan Line* Elements

This Court's recent comments on the interrelationship between the four elements of the *Complete Auto Transit* analysis and the two *Japan Line* elements should be noted prior to proceeding to an examination of the other two elements of dormant foreign Commerce Clause analysis:

> [C]ompliance with the Complete Auto test has relevance to our conclusion that the state tax meets those inquiries unique to the foreign commerce clause. That the tax is a fair measure of the State's contacts with a given commercial transaction in all four aspects of the Complete Auto test confirms both the State's legitimate interest in taxing the transaction and the absence of an attempt to interfere with the free flow of commerce, be it foreign or domestic. *Itel Containers International Corporation v. Huddleston*, 507 U.S. ___, 122 L.Ed.2d 421, at 436 (1993).

1. Multiple Taxation

In *Japan Line*, this Court first enunciated the "enhanced risk of multiple taxation" element of dormant foreign Commerce Clause analysis. *Japan Line* involved the imposition of a property tax. With respect to property taxes, this Court found that pursuant to the custom of nations, Japan, the country of domicile of the owner of the containers, had asserted property taxes on the full value of the containers (441

[6] Barclays in its petition raises the question as to whether this issue was ruled upon by the trial court. Br.Pet. 13, fn. 6.

U.S. at 454) and therefore the assertion of a tax by Los Angeles would inevitably result in actual multiple taxation (441 U.S. at 455). This Court has had the opportunity to explicate the multiple taxation element of dormant Commerce Clause analysis in subsequent cases.

In *Mobil Oil*, this Court distinguished *Japan Line* as follows:

> That case [Japan Line] involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. . . . the factors favoring use of the allocation method in property taxation [taxation in full by the state of domicile] have no immediate application to an income tax. . . . Finally, in Japan Line the Court was confronted with actual multiple taxation that could be remedied only by adoption of an allocation approach. . . . in the present case we are not similarly impelled." 445 U.S. at 448.

In *Itel Containers International Corporation v. Huddleston*, this Court said:

> [T]he foreign commerce clause cannot be interpreted to demand that a state refrain from taxing any business transaction that is also potentially subject to taxation by a foreign sovereign. "Japan Line does not require forbearance so extreme or so one-sided." *Container* [citations omitted] . . . Absent a conflict with a "consistent international practice [or] . . . federal policy" *Container* [citations omitted], the careful apportionment of a state tax on business transactions conducted within state borders does not create the substantial risk of international multiple taxation that implicates foreign commerce clause concerns. 507 U.S.___, 122 L.Ed.2d at 436-437 (1993).

The most thorough explication of the *Japan Line* multiple tax analysis, and the one most directly applicable to the circumstances of these cases, was provided in *Container*, 463 U.S. at 187-193. In *Container*, this Court considered the very method of taxation involved in the present cases and held that what it characterized as actual double taxation was not unconstitutional. In *Container*, 463 U.S. at 187-189, this Court noted four similarities between the circumstances in that case and in *Japan Line*: 1) actual double taxation, 2) a serious divergence in the taxing scheme of California and foreign authorities, 3) a foreign practice consistent with international practice, and 4) a preference for the internationally accepted method by the federal government for purposes of its tax. This Court further noted three differences between the circumstances of *Japan Line* and *Container*: 1) the tax was an income tax not a property tax, 2) the double taxation was not inevitable, and 3) the tax fell not on the foreign owners of an instrument of commerce but on a corporation domiciled and headquartered in the United States. This Court then analyzed the distinctions and determined they constituted a constitutionally significant difference, 463 U.S. at 189. This Court's analysis directs a similar conclusion in these cases.

Colgate and *Container* are identical. The same three distinctions are applicable. Once again, California could achieve the elimination of all double taxation only by deferring to the taxation decisions and income allocation methods made by every other nation. In spite of "double taxation [being] a constitutionally disfavored state of affairs . . . [our analysis] does not require forbearance [by the States] so extreme or one-sided." *Container*, 463 U.S. at 193.

In the circumstances of Barclays, the first two distinctions apply, regardless of the parentage. The tax involved is an income tax where division of the base is the norm, it is not a property tax, and multiple taxation is not automatic.

The clarity and significance of the third distinction is more difficult to determine. In Barclays we have two taxpayers: the first is a California corporation owned by a foreign parent, and the second is a foreign incorporated entity doing business in California.[7] The facts of this case demonstrate that no significance should be attached to ownership. First, the taxpayers are amenable to being taxed in some manner. Second, the only manner of avoiding any complaints is to forgo taxation completely or to have it dictated by the foreign countries. Third, almost seventy years ago this Court accepted the proposition that a foreign-country-domiciled taxpayer could have its State income determined under a formulary method. *Bass, Ratcliff & Gretton, Ltd v. State Tax Commission*, 266 U.S. 271 (1924). No circumstances are presented in this case which justify this Court abandoning this long-established precedent.

2. One Voice

As an initial matter, this analysis must start with the admonition of this Court that "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil Oil*, 445 U.S. at 448. In light of this

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[7] In *Container*, this Court noted that a different level of significance might attach to the incident of the tax when the taxpayer was owned by foreign interests. The Court did not determine whether this would be analytically significant. 463 U.S. at 195, fn. 32.

admonition, the fact that the Federal Government uses the arm's-length method does not automatically require the States do so.

The Executive and Legislative branches have determined that this is not an area where it is *essential* for the Federal Government to speak with one voice. Their judgment has proven correct.

Japan Line stated that an element of the dormant Commerce Clause test is whether the state tax "may impair uniformity in an area where federal uniformity is essential." 441 U.S. at 448. The determination of whether a particular area is one where uniformity is *essential* must in the first instance be a determination to be made by the Legislative Branch which is vested by the United States Constitution with the authority to regulate Commerce. (U.S. Const., art. I, § 8, cl. 3.) As this Court has recognized, it "has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." *Container*, 463 U.S. at 194.

The determination that this is an area where uniformity is not essential has been made by the Congress as evidenced by 1) the action of the United States Senate in refusing to give its advice and consent to a United States/United Kingdom Tax Convention containing a restriction on state taxation specifically intended to prohibit the tax here at issue, Ex. 36C, BJA-238 and Ex. 36D, BJA-311, 2) the Senate's approval of treaties containing no limitation on the States' use of WWCR both in conjunction with, and subsequent to, the United

States/United Kingdom Tax Convention, Stip. ¶ 40, BJA-26-31, and 3) Congressional failure to enact numerous bills which would have prohibited the State tax here at issue, Stip. ¶ 38, BJA-24-25. Of particular significance in the latter regard are the bills which were introduced and considered after the Senate's rejection of the United States/United Kingdom Tax Convention. There could be no doubt what was at stake with respect to those bills, yet no action was taken. Even if the Court is unwilling to consider these actions as an affirmative act of the Congress which would completely preempt a dormant Commerce Clause analysis (see *Western and Southern Life Insurance Company v. State Board of Equalization*, 451 U.S. 648 (1981)), they are, nonetheless, sufficient to establish a Congressional determination that this is an area where federal uniformity is not essential.

Further evidence of the determination that this is an area where federal uniformity is not essential is supplied by the actions of the Executive Branch in years subsequent to the Senate's rejection of the United States/United Kingdom Tax Convention by its request for voluntary state action, its withdrawal of support for a federal legislative solution, Ex. 37I, BJA-439, and its determination that this Court need not consider the petition filed by Barclays in the instant case. Brief of United States, October 7, 1993.

This Court's one-voice analysis in *Container* also took into consideration whether a state tax "might *justifiably* lead to significant foreign retaliation." (Emphasis added.) 463 U.S. at 194. Retaliation in unlikely here. The treaty negotiated between the United Kingdom and the United States, as ultimately approved by the Senate, does not prohibit the tax here at issue. Ex 36D, BJA 393-394. In fact, the United

Kingdom and the United States negotiated additional concessions as the result of the Senate's refusal to give its advice and consent to the restriction the UK sought. Third Protocol to the Treaty, Ex 37H, BJA-436. Finally any retaliation of the sort the British have threatened has been recognized by the Executive Branch as a violation of the treaty now in effect. Testimony of Roger Mentz, Ex 37I, BJA 439 at 443.

In *Container*, this Court was faced with having to determine whether the state tax could interfere with United States foreign policy without the benefit of a fully developed history such as is present in this case. To assist in its determination, this Court made reference to three "objective standards that reflect very general observations about the imperatives of international trade and international relations." 463 U.S. at 194.[8] In the circumstances of these cases, there is no need for this Court to engage in this complex, technical and somewhat speculative analysis because other facts and circumstances have established that uniformity is not essential. More importantly, several United States Senators have filed an *amicus* brief in support of California in this case requesting that this Court leave complex foreign policy analyses to the Senate.

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[8] For example, this Court in *Japan Line*, 441 U.S. at 453, discussed the "asymmetry" of California's tax. There "asymmetry" referred to the fact that Japan did not tax American containers at all, while Los Angeles County wished to tax Japanese containers in part. Petitioner Barclays reads this to mean that because it believes no other jurisdiction, other than a State, uses WWCR there is "automatic asymmetry." Br.Pet. pp. 28-29. If Barclays' definition were correct, then "automatic asymmetry" would exist in *Container*, but this Court found it did not. 463 U.S. at 194-195. Therefore, Barclays' interpretation of "automatic asymmetry" is incorrect.

D. Consistency is Very Important in State Taxation

This Court's decision in *Container* has been the rule of law for over ten years. Congress has certainly had the power to change the result of that decision and has not done so. Overturning the *Container* decision would almost certainly impact the taxation of multinational corporations by the vast majority of the States that use the formulary apportionment principles of UDITPA.[9] *See Moorman Mfg. Co.*, 437 U.S. at 283, fn. 1 (Powell, J. diss.). Each of these States that utilize UDITPA to apportion income has relied on and applied *Container* to the thousands of corporations with multinational income doing business in their States. With multi-year refunds available, a reversal of *Container* will result in a tremendous assault on the States' current revenues. *See Harper v. Commonwealth of Virginia*, 507 U.S.___ , 125 L.Ed.2d 74 (1993).

Therefore, while California's taxing system passes every element of dormant Commerce Clause analysis, the taxes can and should be upheld by this Court also on the basis of *stare decisis*. In *Quill Corporation v. North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91 (1992), this Court offered the following comments with respect to its Commerce Clause-based cases:

> [T]he Bellas Hess rule appears artificial at its edges: . . . This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority. . . . This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the

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[9] Forty-five of fifty states (all which assert taxes on or measured by income) use some form of apportionment.

> "application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation." Northwestern States Portland Cement Co. v. Minnesota [cites omitted].
>
> . . . [A] bright-line rule . . . encourages settled expectations and, in doing so, fosters investment by business and individuals. 119 L.Ed.2d at 109.

CONCLUSION

The "proper and fair method of taxation," *Container*, 463 U.S. at 184, used by California in these cases passes all elements of a dormant Commerce Clause analysis and is a constitutional exercise of California's sovereign power to tax. The judgments of the California courts should be affirmed.

Dated: January 19, 1994

Respectfully submitted,

TOM UDALL
New Mexico Attorney General
DANIEL YOHALEM
Counsel of Record
Asst. Atty. General
P. O. Drawer 1508
Santa Fe, NM 87504
(505) 827-6070

BRUCE J. FORT
FRANK D. KATZ
Sp. Asst. Attys. General
Taxation & Revenue Dept.
P. O. Box 630
Santa Fe, NM 87509

Counsel for Amici Curiae

Nos. 92-1364 and 92-1

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California for the Third Appellate District

---

BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY THE CALIFORNIA SCHOOL BOARDS ASSOCIATION AND THE CALIFORNIA TEACHERS ASSOCIATION; CALIFORNIA FEDERATION OF TEACHERS;

(Continued on inside cover)

Jack A. Dixon
Counsel of Record
Martin Lobel
Lobel, Novins, Lamont & Flug
1275 K Street, N.W., Suite 770
Washington, D.C. 20005
(202) 371-6626
Attorneys for Amici Curiae

BEST AVAILABLE COPY

CALIFORNIA FACULTY ASSOCIATION; CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION; CALIFORNIA STATE EMPLOYEES ASSOCIATION; CALIFORNIA STATE COUNCIL OF SERVICE EMPLOYEES; CALIFORNIA PROFESSIONAL FIREFIGHTERS; AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES; BUILDING AND CONSTRUCTION TRADES COUNCIL OF CALIFORNIA; CALIFORNIA STATE COUNCIL OF CARPENTERS; AND CALIFORNIA INDEPENDENT PUBLIC EMPLOYEES COUNCIL

QUESTIONS PRESENTED

1. Whether a political decision by California's citizens to impose an effective, nondiscriminatory corporate income tax to fund public services which support and encourage international trade should be reversed as an undue burden under the Commerce Clause?

2. Whether the Court should ignore the treaty process to make new foreign policy, nullifying State budget and tax laws, in the absence of clear and convincing proof that the State tax is too burdensome or discriminatory?

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Nos. 92-1384 and 92-1839

In The

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October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
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Respondent.

COLGATE-PALMOLIVE COMPANY,
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FRANCHISE TAX BOARD,
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On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY THE CALIFORNIA TAX REFORM ASSOCIATION AND CALIFORNIA TEACHERS ASSOCIATION; CALIFORNIA FEDERATION OF TEACHERS; CALIFORNIA FACULTY ASSOCIATION; CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION; CALIFORNIA STATE EMPLOYEES ASSOCIATION; CALIFORNIA STATE COUNCIL OF SERVICE EMPLOYEES; CALIFORNIA PROFESSIONAL FIREFIGHTERS; AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES;

BUILDING AND CONSTRUCTION TRADES COUNCIL OF CALIFORNIA; CALIFORNIA STATE COUNCIL OF CARPENTERS; AND CALIFORNIA INDEPENDENT PUBLIC EMPLOYEES COUNCIL

INTEREST OF *AMICI* [1]

The California Tax Reform Association is a California nonprofit organization which represents the interests of the citizens of California in sound tax policy. It was incorporated in 1977 with the support of a coalition of citizens groups. It is supported through public contributions and foundation grants. The Association has participated in the legislative process and litigation about California's use of the unitary accounting method to allocate profit for the past 15 years. It is uniquely able to present arguments on the issues before this Court from the perspective of the California citizen/taxpayer.

Other *amici* are unions and associations which represent both public sector and private sector employees who are part of California's work force. The members of these organizations are the individual taxpayers who will have to bear the direct cost of either additional taxes or lost services if the Petitioners are successful in their pleas to this Court. These *amici*, and the individuals which they represent, have a direct and immediate concern in the outcome of these cases.

SUMMARY OF ARGUMENT

Arguments advanced by Barclays and its *amici*, characterizing California's tax as burdensome, ignore the facts. California law, regulations and the supporting

[1] Pursuant to Rule 37, consent of the parties has been requested and obtained. Copies of the written consents will be filed under separate cover.

regulatory and administrative decisions deal simply, and directly, with the fictitious "chamber of horrors" advanced in their briefs.

California's worldwide combined reporting system (WWCR) enhances, rather than burdens, international trade. The California corporate tax, including WWCR, is an essential element of a successful State policy to enhance international trade and commerce.

The decision to tax all corporations doing business in California on a worldwide combined basis was part of a conscious policy by the citizens of California to develop international trade and foreign investment through public spending on education, training and physical infrastructure. Tax revenue from multinational corporations was an essential element of the plan. To be successful, the tax had to maintain a level playing field for all competitors, whether wholly domestic or multinational.

The investment decisions and the tax policy paid off handsomely. California became a favored site for high technology industry. Foreign investment soared, imports and exports soared. The economy of California became larger than that of most sovereign nations. California's effective taxation of all corporations provided a significant portion of the revenue essential to support this growth and development. It also provided a level playing field for wholly domestic competitors.

The history of public investment in support of foreign trade and the resulting pattern of spectacular growth in foreign trade and investment is inconsistent with the argument that the tax is an undue burden on international commerce.

The foreign policy powers of the United States are delicately balanced between the Executive and the Congress.

The Executive has the broad power to act on diplomatic matters. The right to make treaties, however, is sharply limited by the ratification process. To become the supreme law of the land, a treaty must be ratified by a two-thirds vote of the Senate. The Senate has debated and explicitly rejected a treaty which would have changed California's WWCR system, and the Executive Branch acquiesced to that rejection.

Having failed at the constitutional process, multinational corporations and foreign governments now ask this Court to take over the role of arbiter of foreign policy in the international tax arena and nullify California law. But there should be no federal preemption of State law, absent legislation or a treaty. The Commerce Clause does not protect foreign corporations from paying nondiscriminatory State taxes.

I. THERE IS NO CREDIBLE EVIDENCE THAT CALIFORNIA'S TAX ACCOUNTING METHOD BURDENS FOREIGN COMMERCE.

A. The Claimed Million Dollar Costs of Compliance Are An International Red Herring.

Barclays, and a number of its *amici*,[2] argue that either compliance with WWCR is virtually impossible or so expensive for foreign-based multinationals as to constitute discriminatory treatment. They claim international businesses do not otherwise keep the data required for WWCR. Their assertions are not correct.

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[2] See Briefs of Reuters Limited, Confederation of British Industry, Council of Netherlands Industrial Federations, Federation of German Industries and the Association of German Chambers of Industry and Commerce, Japan Tax Association and Banque Nationale De Paris.

A WWCR calculation requires just seven basic numbers: 1) worldwide income, 2-4) worldwide property, payroll and sales, and 5-7) California property, payroll and sales.[3] Jerome Hellerstein, a venerated authority on state taxation, noted:

> The fact is that much of the data required for formulary apportionment already are being gathered by multinationals for business, financial and reporting purposes, for tax returns, and for SEC and other regulatory agency filings. Foreign currency transactions must be converted into dollar figures for such purposes. Furthermore, with the increasing globalization of industry and of the worldwide accounting firms that service multinational enterprises, and the computerization of accounting records, compliance with apportionment requirements on a worldwide basis is not the formidable task it once was. *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, Tax Notes, August 23, 1993, at 1142.[4]

Barclays' and its *amici*'s arguments also fail when their claims are compared to the text of the California regulation,

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[3] The source of such numbers for the Barclays Group is in the record. See Exs. 51E, 51F, 51G, 51K, 51Q, 51R, 51S, and 51U. Respondent's expert witness, John Shank, in his testimony at trial, illustrated how various exhibits could be used to construct a WWCR. Reporter's Transcript 2039-2097.

[4] For additional comments on the compliance arguments, see Benjamin F. Miller, *A Reply to "From the Frying Pan to the Fire,"* State Tax Notes, September 27, 1993, p. 705.

§ 25137-6.[5] Barclays Joint Appendix (BJA) Ex. 12, BJA-50-57.

1. Separate books are not needed.

First, the claim is made that a separate set of books and records, stated in California accounting terms, must be established. For example, the *amicus* brief of the Confederation of British Industry at page 14 states:

> Thus, in practical terms, to comply fully with worldwide combined reporting a foreign multinational would have to keep a separate set of books for each foreign corporation using the accounting rules of each WWCR jurisdiction in which any member of the group operates.

Barclays and Reuters merely imply that a separate set of books is required. Reuters at p. 3, states:

> It is the international norm that a multinational enterprise keep all of its books and records in conformance with the requirements of its home country. It is *not* the international norm that a multinational enterprise keep *all* of its books and records in accordance with the tax and accounting requirements of *every* country in which it does business. (Emphasis in original.)

They create the impression, without saying so directly, that WWCR requires a separate set of books and records. The care Reuters and Barclays show in their briefs is understandable. Both have direct filing experience with the States: Barclays with California, and Reuters with New York.

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[5] The California regulation is an adaptation of 26 C.F.R. §1.964-1. If Petitioner Barclays' allegations that the California regulation violates the Due Process Clause because of vagueness and the lack of reviewable standards are accepted, then the federal regulation apparently is also invalid.

In Barclays' case, the California courts found that the actual cost of compliance, for a worldwide combined report for Barclays Bank International, as evidenced by the bills it received from a major accounting firm, was $900 to $1,250 annually.[6] The returns were acceptable to California except as to the scope of the unitary business.

Reuters, a United Kingdom corporation, filed returns with New York State on an apportioned basis for decades before their sudden assertion that the returns would cost in excess of a million dollars annually to prepare.[7] The New York courts found Reuters' claim disingenuous, based on their prior filing experience and the fact that they were able to file their "million dollar" return within ten days of learning that New York was going to require them to file. *Reuters Ltd. v. Tax Appeals Tribunal*, No. 186, slip op. New York Court of Appeals (N.Y. Oct 12, 1993).

California's regulation does not require that separate books and records be maintained. Regulation § 25137-6, as its starting point, uses either "a profit and loss statement prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained," Ex. 12, BJA-50, (b)(1)(A), or "the consolidated profit and loss statement prepared for the related corporations . . . for filing with the Securities and Exchange Commission . . . [or] for reporting to shareholders. . . ." BJA-51, (b)(2). Adjustments are then made to these statements, if material, BJA-54, (b)(3)(C), for differences between foreign and United States Generally Accepted

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[6] Appendix to the Petition, D-19, fn. 9.

[7] Affidavit of Michael J. Canty, Financial Manager — Taxation of Reuters, Ltd., submitted as evidence in the New York matter.

Accounting Principles (GAAP) and California tax accounting standards. A second and separate system is not required, nor even suggested.

2. The accounts need not be in English or in dollars.

The claim is made that the accounts must be kept in dollars and in English.[8] This is incorrect. Regulation § 25137-6 provides that the calculation of income, Ex. 12, BJA-51, (b)(1)(D) and (b)(2), and the apportionment factors, BJA-55, (c)(1)(E), and BJA-56, (c)(2)(C), are to be made in the currency of the parent company. There is no requirement about which language a reporting firm must use in its accounting records. Use of the language of the parent company is implicitly acceptable. In any event, the consolidated accounting records of Barclays are maintained in English.

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[8] "Reports also must be in English and in U.S. dollars." *Amicus* brief of Confederation of British Industry, p. 12.

"[A] foreign based multinational corporation will not ordinarily have to restate its accounts in accordance with the accounting principles of the United States or one of its states, nor need to translate its accounts into U.S. dollars or all its records in English. WWCR requires such restatement and translation, . . ." *Amicus* Brief of Council of Netherlands Industrial Federations, p. 5-6.

"WWCR requires corporate taxpayers to provide details of taxable income for worldwide operations translated into English and adjusted to U.S. and even specific state taxation accounting principles and U.S. currency." Amici brief of Federation of German Industries and Association of German Chambers of Industry and Commerce, p. 7.

Barclays also suggests, that in order to file under WWCR, it must maintain its records in United States dollars and in English. Barclays Opening Brief, p. 44.

3. Conforming foreign financial statements to the United States Generally Accepted Accounting Principles (GAAP) are routinely required.

The claim is made that a United States GAAP conversion is not routinely made for other purposes.[9] These claims are false. First, there is no requirement that accounting records be maintained in accordance with United States GAAP. There is, however, a requirement to convert the regularly maintained records to United States GAAP. But adjustments are to be made only if material. Ex. 12, BJA-54, (b)(3)(C). If the adjustments are not material, they do not have to be made.

Further, U.S. GAAP statements are required for companies which trade on United States security exchanges. In this case, Barclays had, in fact, prepared United States GAAP statements for other purposes. It prepared a prospectus that was used to market its securities here. Stip. ¶ 51 and Ex. 51G, BJA-40. Examination of the Barclays prospectus shows only five material differences between U.S. GAAP financials and the United Kingdom version. Furthermore, trial testimony, by Barclays' own expert witness, established that of the GAAP differences identified, only one had significance for California tax purposes and that the information for the adjustment was readily available. RT 1004-1012. U.S. GAAP statements are also frequently required of foreign-based businesses by United States banks as a condition of getting a loan.

It should also be noted that following the Bank of Credit and Commerce International scandal, state and federal bank regulators have tightened the reporting and accounting requirements for international banks seeking to do business in

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[9] See footnote 8.

the United States. Banks must show their sources of capital and the full financial structure of their affiliated companies. These requirements far exceed the requirements California imposes in connection with its tax returns. See, The Foreign Bank Supervision Enhancement Act of 1991, P.L. 102-42, Title 2, Subtitle A.

4. WWCR fairly allocates bank profits.

One *amicus*, Banque National De Paris, hereinafter Banque, claims that currency exchange accounting problems arise under California WWCR. Banque's claim ignores the fact that the California regulation recognizes the difference between domestic and foreign companies by allowing each of them to determine income and exchange factors in the currency of the parent company.

Banque complains, pp.7-10, that a United States bank and a French bank will have different profits and losses, as expressed in dollars, when the United States bank makes a loan in dollars and the French bank makes a loan in francs because the relative values of the franc and dollar change over time. The assertion is correct, but the conclusion drawn from it is wrong. Their incomes are different. The French bank calculates its income in francs, and the United States bank calculates its income in dollars. The French bank will be taxed fairly under California's regulations because it will report its profitability in the currency of the French parent, the French franc.

For example, if a United States bank makes a franc loan, there are two calculations which must be made to determine income. First, there is the interest and fee profit on the loan itself. Second, there is the profit or loss on the foreign exchange transaction when the bank makes the French franc loan. That will be determined when the loan is repaid. Similarly, a French bank which makes a dollar loan also has

an exchange transaction to account for in determining income. Not surprisingly, the exchange transactions will yield a different result for each bank during the same period. If the dollar strengthens, the United States bank has an exchange loss on lending francs and the French bank has an exchange gain on lending dollars. As long as both transactions are accounted for in the currency of the parent, the net result will be equivalent.

Banque cites two compliance concerns, pp. 4-6. The first is a contrived example involving California's bad debt rules. Under California law, banks and financials are allowed to take a deduction under either the specific charge-off method (a loss is taken when a loan is written off) or under the reserve method (past experience is used to estimate future losses, and a loss is allowed even though it is not yet incurred). In neither circumstance is the accounting particularly complex.[10] The specific charge-off speaks for itself, and the reserve method merely uses past charge-offs to predict future experience. The experience factor for California purposes is based on either three or six years' of experience. Banque complains about neither of these methods. Its example is based upon a facts-and-circumstances exception which allows for a deduction for more than past experience would allow if present circumstances indicate it is appropriate. Furthermore, the procedure discussed is not the only means of establishing the need for an additional reserve but merely one method of showing the need for an additional deduction.

Banque's second compliance concern deals with the establishment of historic cost of fixed assets (the reference to

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[10] In point of fact, Barclays uses the reserve method for accounting for bad debts for its financial reporting purposes based upon five years' of experience. Ex. 51E, p. 29.

financial assets appears to be included for purposes of obfuscation rather than relevance). Banque's complaint is based upon the assumption that foreign multinationals do not keep consolidated books and records prepared in a manner similar to that used in the United States. Whatever the case may be with Banque, it is not the case with Barclays. Barclays' published financial statements allow for the determination of the value of fixed assets at historic cost expressed in Sterling.[11]

Banque's other complaints are equally contrived. For example, the three elements of disproportionality on pages 11-12 of Banque's brief assume the United States tail will wag the foreign dog because they assume that all the calculations must be done in dollars. Banque ignores the fact that the California regulation provides for factor and income calculations to be made in the currency of the parent company. The primary reason for this approach was to look at the entire corporation fairly from the perspective of its home country.

WWCR will give a much fairer picture of a bank's California profit precisely because it ignores the details of the individual transactions and looks for a fair apportionment of the overall result. If California were to use the transactional system, it would be mired in the same arguments Banque raises in its brief. In that case, the bank's arguments would

[11] United Kingdom GAAP allows for the revaluation of fixed assets. Barclays has taken advantage of this treatment. When assets are revalued, a reserve is established as a Note to the Financial Statements which includes the amount of the revaluation. See Ex. 51E. This reserve can then be used to adjust balance sheet values back to original cost and to adjust depreciation for income statement purposes. Testimony of Bernard Caldwell (expert witness called by Barclays), RT-1012.

be used to explain, transaction by transaction, why there was no income in California.

WWCR limits the need for time-consuming and expensive audits to determine income. This facilitates trade, it does not limit it.

B. The "Burdens" Imposed Upon Corporate Taxpayers Have Allowed California To Attract Foreign Investment.

1. California has attracted international investment.

If California were a separate country, its economy would be the seventh largest in the world. It has a diverse regional economy, characterized by advanced technological capabilities, a vast and expanding international market and, until recently, rapid rates of economic growth. Among States and regions of the United States, it has among the highest levels of integration with the world economy; it leads the nation in exports as a percentage of its gross domestic product[12] and in direct foreign investment.[13] In fact, the extent of the internationalization of the California economy is far greater than that of the U.S. as a whole. Thus, in terms of public policy adaptation to the growing internationalization of the economy, California's economy is on the cutting edge.

Another feature of California's economy has been its high rate of public sector investment. Rapid economic growth has been accompanied by public investment in universities and schools, highways and mass transit, water projects and parks,

[12] *Foreign Direct Investment in California*, a joint report of California's Trade and Commerce Agency, the Office of Foreign Investment, and the Office of Economic Research, November 1993, p. 7.

[13] *Ibid.*, pp. 12-15.

libraries and health facilities. For several generations, its publicly supported system of higher education has been unparalleled in the world, particularly in the range of educational opportunities afforded its citizens. Historically, Californians have paid taxes at rates higher than in most parts of the United States in order to stimulate or at least stay abreast of rapid economic and population growth.

Small wonder, then, that multinational companies have sought to be active participants in the California economy. California has continually led the nation in net foreign investment. For example, virtually half of all Japanese investment in the United States during the 1980's was in California, a proportion far higher than one would expect from the size of its economy, which is approximately 12 percent of the U.S. economy.[14]

Japan is the leading source of foreign investment in California with 33.4 percent of the total in 1991.[15] The total book value of Japanese investment in California was $27.3 billion.[16] The next largest sources were the United Kingdom with $11.6 billion and the Netherlands with $11.1 billion.[17] Other countries have become increasingly important as sources of investment. For example, direct investment from Taiwan, Hong Kong, Singapore and South Korea grew collectively by 90 percent since 1988.[18]

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[14] *Ibid.*, p. 10.

[15] *Ibid.*, p. 5.

[16] *Ibid.*, p. 4.

[17] *Ibid.*

[18] *Ibid.*, p. 6.

When a company, such as Barclays, makes a decision to enter the California market, it immediately has access to the educated labor force, the technological capabilities, the transportation facilities, the markets, and the communications infrastructure which California taxpayers have helped pay for.

When a multinational corporation invests in a State, it becomes a taxpayer and a corporate citizen. As a taxpayer, it assumes the obligation to contribute to the maintenance of the public sector investments from which it benefits. It knows the tax structure and policies it will face before it takes the first step. It is also able to express its concerns in the political process about the business climate in which it has chosen to operate. California's legislators and governors are highly attuned to the concerns of those who do business in the State. The business community is influential in California's political processes.

Many of the foreign investors compete directly with California-based corporations and with each other in the California market. If some multinational corporations are given the opportunity to game the international tax system while wholly domestic corporations cannot, an essential attraction of the State — a level competitive playing field — will be destroyed and wholly domestic businesses will be put at a severe competitive disadvantage.

2. California's tax structure allows it to effectively deal with an increasingly complex international economy.

As tax collector for a highly internationalized, advanced information economy, the Franchise Tax Board has continuously improved its techniques of tax enforcement. Court decisions and administrative practice have moved the system from a relatively simple past to the complexities of

modern business enterprises.[19] If California were forced to adopt the arm's-length method used by the federal government, it would be even less able to collect taxes from multinational corporations than the federal government is because of the disparity of resources — and, the federal government's efforts are admittedly inadequate to the task.[20]

3. The California Bank and Corporation Tax, which is based upon use of WWCR, provides State revenue in excess of $5 billion dollars that is essential to the creation of the infrastructure and skilled labor pool which has made California an attractive place to invest.

The California Bank and Corporation tax is the third largest source of revenue for the State's general fund. It is expected to raise $5.1 billion, or 12.4 percent of the State's general fund revenue in 1994-95. Personal income tax is expected to account for more than $18 billion. Sales tax will add $12.7 billion.[21]

The general fund supports the State's educational system. In the 1994-95 budget, a budget which is sharply reduced from previous levels because of the State's, and in fact the world's, continuing economic problems, 9.8 percent will go

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[19] Benjamin F. Miller, "Worldwide Unitary Combination: The California Practice," *The State Corporate Income Tax*, Hoover Institute Press, Stanford University, 1984, at 132.

[20] Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes From Multinational Corporations*, Tax Notes, June 28, 1993, at 1841; John B. Judis, *Tax Brake, Clinton's Corporate Giveaway*, The New Republic, August 23, 1993, at 15.

[21] *Governor's Budget Summary 1994-95*, Pete Wilson, Governor, State of California, Sacramento, pp. 89-95.

to higher education and 44.2 percent will support education from grades K-14.[22]

The skilled work force produced by the excellent California university system attracts foreign investors.[23] Of the total foreign investments made in the United States in the field of electronics and electric equipment manufacturing, 13.5 percent was in California. Of the foreign investment in instrument manufacturing in the United States, 10.8 percent was made in California.[24]

Despite high tax rates, foreign investors are continuing to come to California to take advantage of the skilled work force. While the growth in foreign investment in California slowed from the very rapid rates of the 1980's, in 1991 it continued at 8 percent over prior years.[25] The 8 percent growth in investment was achieved despite a severe statewide recession, economic problems in the source countries, and the existence of high tax rates.

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[22] *Ibid.*, p. 80.

[23] *Foreign Direct Investment in California*, *op. cit. supra*, p. 1.

[24] *Ibid.*, p. 8.

[25] It is ironic to note that California enjoyed its greatest growth with respect to international investment in the years prior to 1988 when it moved from mandatory worldwide combined reporting to elective water's-edge reporting.

II. FOREIGN GOVERNMENTS AND CORPORATIONS SHOULD NOT BE INVITED TO USE THIS COURT TO CHANGE A SETTLED FOREIGN POLICY OF THE UNITED STATES WHICH IS THE PRODUCT OF ITS POLITICAL PROCESSES.

The Constitution gives the Executive Branch the broad power to handle the diplomatic relations with foreign governments, while it strictly confines any use of foreign policy power to override State and federal law to the treaty process. "[T]reaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; . . ." U.S. Const., art. VI, cl. 2.

> It is to be noted further that for the United States *treaty* law is not just the "supreme Law of the Land," but that it comes into being through a singularly exacting sequence. Treaties are entered into by the United States with other nations, either directly or through adherence to a common document. They are signed by a member of the executive branch. Thereafter the Senate of the United States must by resolution, two-thirds of the senators present concurring therein, give its advice and consent to ratification. This advice and consent having been given — by an extraordinary majority — the president then ratifies and confirms the treaty in an instrument of ratification. At that point, under Article VI of the Constitution the said treaty "shall be the supreme Law of the Land." Daniel Patrick Moynihan, *On the Law of Nations*, Harvard University Press, 1990, pp. 173-74.

This "singularly exacting" process gives great significance to the adoption *or* the rejection of a treaty. When the Senate gives its advice and consent to a treaty and it is ratified, the treaty becomes the supreme law of the land and the policy of

the United States. When the Senate refuses to give its advice and consent to a treaty, its provisions do not become the supreme law of the land, and the policy which the treaty represents can no longer be used to nullify state law. If this were not so, the President could establish the supreme law of the land *ex cathedra* regardless of the Senate's views. There would be no need for the Senate's advice and consent. The reasons for this balance of powers are found in the circumstances which gave rise to the adoption of the Constitution.

One of the major motivations for the adoption of the Constitution was the need to create a central government which could deal with other nations on an equal footing in the area of commercial relations. To this end, the power to make treaties was granted solely to the federal government. U.S. Const., art. I, § 10, cl. 1 and art. II, § 2, cl. 2.

The delegation of the treaty power to a federal government, while recognized as necessary, was viewed with trepidation. States, which under the Confederation were sovereigns with their own power to enter into treaties, were concerned that the delegation of this power to the central government would result in their interests being disregarded. Consequently, the structure of the government was designed to prevent this occurrence. The Senate, one of the two bodies contained in the Legislative Branch, was created as a representative of the States with each State having equal rights of representation. Furthermore, this right of equal representation could not be changed without the consent of the affected State. U.S. Const., art. V.

This Court, in recounting the history of the Commerce Clause, has recognized that protection of the sovereignty of the States is provided by the very structure of our federal government. This Court's Commerce Clause discussion is

even more apt with respect to the exercise of the treaty power. In *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), this Court stated:

> . . . Apart from the limitation on federal authority inherent in the delegated nature of Congress' Article I powers, the principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress. [footnote omitted] . . . They were given more direct influence in the Senate, where each State received equal representation and each Senator was to be selected by the legislature of his State. [citation omitted] The significance attached to the States' equal representation in the Senate is underscored by the prohibition of any constitutional amendment divesting a State of equal representation without the State's consent. [citation omitted]
>
> The extent to which the structure of the Federal Government itself was relied on to insulate the interests of the States is evident in the views of the Framers. James Madison explained that the Federal Government "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments. (citation omitted)" . . . "it was a favorite object in the Convention" to provide for the security of the States against federal encroachment and that the structure of the Federal Government itself served that end. [citation omitted] . . . equal representation of the States in the Senate, which he saw as "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an

> instrument for preserving that residuary sovereignty." [citation omitted] . . . "the residuary sovereignty of the States [is] implied *and secured* by that principle of representation in one branch of the [federal] legislature" [citations omitted] . . . the Framers chose to rely on a federal system in which special restraints on federal power over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.
>
> * * *
>
> We realize that changes in the structure of the Federal Government have taken place since 1789, not the least of which has been the substitution of popular election of Senators by the adoption of the Seventeenth Amendment in 1913, and that these changes may work to alter the influence of the States in the federal political process. [footnote omitted] Nonetheless, against this background, we are convinced that the fundamental limitation that the constitutional scheme imposes . . . is one of process rather than one of result.
>
> * * *
>
> . . . [T]he principal and basic limit on the federal commerce power is that inherent in all congressional action — the built-in restraints that our system provides through state participation in federal governmental action. The political process ensures that laws that unduly burden the States will not be promulgated. In the factual setting of these cases the internal safeguards of the political process have performed as intended. *Garcia*, 469 U.S. 550-556.

Concerns for the sovereignty of the States were expressed through the Constitutional requirement that the Senate, by two-thirds of its members present, give its advice and consent to a treaty, U.S. Const., art. II, § 2, cl. 2. In this regard, our Constitution differs markedly from the structure of government in the United Kingdom, and most other national governments in the world, where the conduct of foreign affairs is left almost exclusively in the hands of the Executive Branch. It should not be forgotten that in designing the structure of our constitutional system, the Framers had, as a model they wished to avoid, the government of the United Kingdom.

In the debate which occurred on the Senate floor during the consideration of the US/UK treaty, Senator Frank Church recalled the concerns of our founding fathers as follows:

> There are two important principles at stake in this treaty. The first concerns the role of tax treaties in our constitutional system. Whatever tax treaties are good for, they should not be used to usurp for the executive branch of Government the power to impose major changes in internal tax policy. Yet, the United Kingdom Treaty does precisely this.
>
> For some ten years, Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty.
>
> * * *
>
> The second important principle concerns the proper way for resolving disputes with our federal system. . . . the States were never consulted before their tax powers were bargained away. . . .
>
> . . . Congress is the forum in which disputes with the federal system [are] meant to be resolved. . . .

> . . . The original purpose for the Senate's role in the treaty process was to protect the interests of the several States in treaty matters. The framers feared that to give the executive branch of the Federal Government free rein in the treaty process would enable the President to ride roughshod over the States. We may have waited a while to see that fear confirmed, but that is exactly what article 9(4) of this treaty does. It demonstrates that the fears of the framers of our Constitution were well founded. 124 Cong. Rec. S. 18416-18417, June 22, 1978.

The failure of the United Kingdom to appreciate this fundamental difference in the form and structure of our government may explain its concerns with respect to what happened to the bilateral tax treaty which we negotiated with it, but it does not give the United Kingdom the power to dictate how our system ought to function or how this Court should construe our institutional framework. One of the primary concerns of the Framers was to preserve the individual sovereign rights of the States. The fact that the United Kingdom does not share these concerns is of little moment in this Court's interpretation of the Constitution and the significance of acts taken pursuant to its requirements.

III. THE CALIFORNIA BUDGET AND TAX CODE ARE THE HEART OF THE STATE'S POLITICAL PROCESS AND SHOULD NOT BE SET ASIDE ABSENT SPECIFIC FEDERAL LEGISLATION OR TREATIES.

Even when the federal government has legislated, it does not follow that State legislation on the same subject is automatically preempted. The test requires the presence of persuasive reasons ". . . either that the nature of the regulated subject matter permits no other conclusion or that Congress has unmistakably so ordained." *Florida Lime and Avocado*

Growers v. Paul, 373 U.S. 132, 142 (1963). Indeed, this Court sustained a State tax that differed from the federal tax, even when Congress thought State law would follow federal law, because Congress did not *require* States to follow federal law. *Amerada Hess Corp. v. New Jersey*, 490 U.S. 66, 70 (1989). In this case, Congress has refused to legislate and the Senate refused to ratify the treaty which would have preempted the State law at issue in these cases.

In this case, multinational corporations and foreign governments are asking this Court to use the Commerce Clause of the Constitution, art. I, § 8, cl. 3, and the so-called "Dormant Commerce Clause analysis" to nullify a State law for foreign policy reasons. They cite the anger of foreign governments, including, in the case of several foreign government *amici*, their own protests. They argue that there is a constitutional requirement that the United States "speak with one voice" on foreign commercial issues and that, absent federal legislation or treaties, this Court is that voice.

In the process, Petitioners are asking this Court to take the drastic step of nullifying California's political decisions that could cost California's taxpayers over $4 billion in tax revenue losses. The refunds, and the additional loss of revenue to the State treasury, will force the State to weaken its infrastructure, will put its wholly domestic companies at a competitive disadvantage, and will force a reallocation of benefits and burdens which have already been distributed, after bitter budget debate, by the California Legislature. It will come at a time when California is reeling from the impact of wildfires and now earthquakes. Each of these events by itself sends tremors through a state's budget. Cumulatively, these events will have the fiscal impact of an earthquake of at least 9.0 on the Richter scale.

What impact does $4 billion have on California's budget? In terms of services, it means, for example, the loss of ability to pay for over 100,000 teachers, send 1 million college students to State universities, or provide health coverage for over 5 million uninsured Californians. Based on current proportions in the budget, elementary and secondary education would lose $1.6 billion, higher education would lose $480 million, and health and welfare programs would lose about $1 billion. In a State which has struggled to provide basic services and resolve on-going budget deficits, it would be a staggering blow to its ability to maintain the level of public services which have contributed so much to the environment which foreign multinationals have sought.

Alternatively, the impact on California's other taxpayers would be devastating. To replace the $4 billion would mean an increase in personal income taxes of 25 percent on all taxpayers for one year. It would mean an increase in State sales taxes of 30 percent, or 2 1/2 cents. It would mean an increase of approximately 80 percent in the Bank and Corporation tax for wholly domestic companies while allowing multinational corporations to essentially escape the tax. Indeed, if Barclays and Colgate prevail, our wholly domestic companies will have to compete against multinational corporations which pay no income taxes whatsoever on their exports to the U.S. because in many countries there is no corporate income tax, only a Value Added Tax on products which is rebated to a corporation once it exports the product.

Thus, the potential costs to the State of California will be significant for every citizen and taxpayer. Either California must shift the tax burden from multinational corporations to wholly domestic corporate and individual taxpayers, or make significant cuts in vital public services thereby weakening one

of the very features which benefitted these multinational investors in the first place.

Who would be hurt by such a decision? The damage caused will be most obviously to all taxpayers and to public services, but, in addition, will disadvantage wholly domestic, small and local businesses. The prohibition of an effective method of tax enforcement — WWCR — gives multinational corporations a tax shelter that is not available to wholly domestic companies, whose income is apportioned by formula.

Barclays and Colgate demand all of this despite their failure to prove that the WWCR method is discriminatory, despite their failure to prove that the WWCR method will, in fact, result in double taxation, and despite their failure to prove that the method is burdensome. Barclays' and Colgate's real complaint is that they do not want to pay taxes. They want to continue to be able to shelter income in tax havens such as the British Crown Colony of the Cayman Islands which is now the fifth largest banking center in the world.

This court should respect us as citizens and taxpayers and protect our budget process from foreign assault. It should not allow itself to be used by multinationals as a tool to undermine our Nation's fundamental democratic institutions.

Further, we believe that the language in the *Container* case, 463 U.S. 159, at 194 (1983), which suggests that if there is a credible threat of foreign government retaliation, it may be appropriate for this Court to use foreign policy as a reason to nullify State law, under the Commerce Clause, should be disclaimed. The language opens the door to foreigners who will make threats just to reenforce their "Dormant Commerce Clause" arguments. The threats will give foreign governments a stronger hand in shaping state fiscal policy than we give our own citizens.

CONCLUSION

For the foregoing reasons, *amici curiae* urge this Court to affirm the decisions of the California courts.

Dated: January 19, 1994

Respectfully submitted,

By Jack A. Blum
Counsel of Record
Martin Lobel
Lobel, Novins, Lamont & Flug
1275 K St. N.W. #770
Washington, D.C. 20005
(202) 371-6626

Attorney for Amici Curiae

(38) (10)

Supreme Court, U.S.
FILED
JAN 19 1994
OFFICE OF THE CLERK

Nos. 92-1384 and 92-1839

In The

Supreme Court of the United States

October Term, 1993

No. 92-1384

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

No. 92-1839

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeals Of The State Of California, In And For The Third Appellate District

AMICUS CURIAE BRIEF OF CITIZENS FOR TAX JUSTICE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

JONATHAN P. HIATT*
1313 L. St., N.W.
Washington, D.C. 20005
(202) 898-3200
*Counsel of Record

January 19, 1994

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Of Counsel:

PROFESSOR RICHARD POMP
University of Connecticut
School of Law
65 Elizabeth Street
Hartford, CT 06105-2290
(203) 241-4694

PROFESSOR OLIVER OLDMAN
Harvard Law School
1563 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4622

PROFESSOR MICHAEL MCINTYRE
Wayne State University Law School
468 West Ferry Mall
Detroit, MI 48202
(313) 577-3944

QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is pre-empted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

QUESTIONS PRESENTED – Continued

In its *Amicus Curiae* Brief, Citizens for Tax Justice shall address only the first two questions set forth above.[1]

[1] *Amicus* Citizens for Tax Justice has received consent from all parties to file this brief and will file written confirmation of those consents with the Clerk of the Court.

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AMICUS CURIAE BRIEF OF CITIZENS FOR TAX JUSTICE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

STATEMENT OF INTEREST OF AMICUS CURIAE CITIZENS FOR TAX JUSTICE

Citizens for Tax Justice (CTJ) is a coalition of national public interest organizations, labor unions, and citizens groups around the country. CTJ was founded in 1979 and is headquartered in Washington, D.C.. Through its member organizations, CTJ represents the interest of tens of millions of middle and lower-income taxpayers. Several of CTJ's members also represent state and local government workers around the country, including California.

As a representative of middle and lower-income taxpayers and of state and local government workers, CTJ has a vital interest in the outcome of the cases before the Court. The decision of the Court in these cases will affect the right of California and other states to assess a fair share of the tax burden on multinational corporations that do business in those states. The pending cases will therefore directly affect both state and local taxpayers and state and local government workers, since a decision against the State of California in these cases is likely to mean increased personal taxes, reduced government services or both in the states which are affected.

SUMMARY OF ARGUMENT

This case involves an issue that the states fought – and won – in the negotiations over the U.S.-U.K. tax treaty. Essentially, Petitioner Barclays Bank PLC (hereinafter "Barclays") is asking this Court to renegotiate the U.S.-U.K. tax treaty by holding that it is unconstitutional for California to apply worldwide combined reporting

(WWCR) to members of a unitary business controlled by Barclays, a British corporation. Yet both the United States and the United Kingdom consented to the application of WWCR in exactly this situation when they entered into the U.S.-U.K. tax treaty.

To be sure, an earlier, unratified version of the treaty, negotiated by the Executive branch, contained an unprecedented provision that would have prevented the application of worldwide combined reporting (WWCR). Exercising its Constitutional powers, the Senate refused to ratify this version of the treaty.

The Executive branch could obtain Senate approval only after this restriction on WWCR was removed from the treaty. In order to compensate the United Kingdom for the continued right of the states to use WWCR and in order to induce it to enter into a treaty that permitted WWCR, the Executive branch made concessions to the U.K. in other provisions of the treaty. The Senate then ratified the treaty with these concessions and without any restrictions on WWCR. These events, as well as statements by both governments, make it perfectly clear that the United Kingdom and the United States recognized that states could apply WWCR to a taxpayer such as Barclays. Indeed, Barclays is not claiming that California's use of WWCR violates the treaty.

This Court is now being asked to do what the United Kingdom and the Executive branch of the United States government could not do through the treaty process and outlaw WWCR. But the Senate is the proper body to renegotiate the treaty. Only through renegotiation of the treaty could the Senate reclaim the concessions that were

previously made to the United Kingdom as a quid pro quo for WWCR.

The Executive branch and the United Kingdom made the best bargain they could at the time in light of the Senate's sentiments. Certain past and current officials in the Executive branch have been unhappy with the treaty's resolution of the WWCR issue and have attempted through the political process to curtail this method of taxation. They have been notably unsuccessful in convincing the Legislative branch of the government to exercise its Constitutional powers to regulate interstate and foreign commerce by passing legislation governing WWCR. They have been more successful in using political suasion in encouraging states to curtail voluntarily their taxing powers. In response to these pressures, California has abandoned the mandatory use of WWCR. The Court should find that, under the facts presented in these cases, the federal government has not abandoned, by law, policy or action, its approval of California, or any other state's right, to impose WWCR should it determine to do so.

ARGUMENT

NEGOTIATIONS OVER THE U.S.-U.K. TAX TREATY MAKE IT CLEAR THAT BOTH THE UNITED STATES AND THE UNITED KINGDOM AUTHORIZED THE APPLICATION OF WORLDWIDE COMBINED REPORTING TO CORPORATIONS SUCH AS BARCLAYS

The events surrounding the ratification of the U.S.-U.K. tax treaty make it clear that both the United States

and the United Kingdom authorized the application of WWCR to corporations such as Barclays. The California tax on Barclays is consistent with the treaty and reflects the understanding of both countries. Because WWCR is consistent with the treaty, which is the supreme law of the land, it cannot be invalidated under a dormant foreign commerce clause analysis.

In 1975, the Executive branch negotiated a revision of the existing tax treaty with the United Kingdom. Article 9(4) of this proposed revision would have barred California (and other states with similar tax regimes) from imposing WWCR on British corporations such as Barclays.[2] The proposed Article 9(4) was recognized by all parties to be an attack on WWCR. For example, the Treasury Department's June 8, 1976 submission of this version of the treaty to the President stated:

> "This provision represents the first attempt to bind State and local taxing authorities by a substantive provision of the treaty (other than nondiscrimination). Under the basic rules of our other tax conventions a contracting State entering into such tax conventions is prohibited from taking into account, in determining the tax liability of an enterprise doing business in that contracting State, the income, expenses, etc. of related enterprises of the other contracting State, or in other countries of those enterprises if those enterprises are not engaged in business in the contracting State, except to the extent that

[2] Article 9(4) in the final treaty does not bar either the United States or the United Kingdom from extensively using formulary apportionment within the context of an arm's length standard. This aspect of Article 9(4) was uncontroversial.

> inter-company transactions are not conducted on an arm's length basis. This treaty, for the first time, extends this limitation to State and local tax authorities with respect to enterprises controlled by United Kingdom residents. This limitation is directed at the practice of a few states which are attempting to take into account the income on a consolidated basis of all related foreign enterprises in assessing the State income tax of a single member of the related group doing business in the State."[3]

This unprecedented attempt to limit state taxation touched off a heated and extensive debate. Ultimately, the treaty could not be ratified without a reservation to this part of Article 9(4).

The Senate's reservation was a blow to the United Kingdom, whose business community felt strongly about obtaining a prohibition on WWCR. The reservation also foiled the United Kingdom's attempt to use the treaty to circumvent Congress' consistent refusal to enact legislation outlawing WWCR. Such legislation had been debated for ten years prior to the introduction of the U.K. treaty; even in the midst of debate over the treaty there were suggestions to substitute a legislative response for Article 9(4), but the Congress adamantly refused to interfere with the taxing power of the states.[4]

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[3] Reprinted in P-H Tax Treaties, United Kingdom – Income Tax Treaty, at 89,050 (1976).

[4] For some of the bills that would have, inter alia, affected the states' use of WWCR, see H.R. 11798 (1965); S. 916 (1969); S. 317 (1971); S. 4080 (1972); S. 2173 (1977); S. 1688 (1979); H.R. 5076 (1979); H.R. 5903 (1979); H.R. 8277 (1980); H.R. 1983 (1981); H.R. 6402 (1982); H.R. 2918 (1983); H.R. 3243 (1983); S. 1225 (1983); H.R. 4940 (1984); H.R. 6146 (1984); S. 3061 (1984); H.R. 3980 (1985); S. 1113 (1985); S. 1974 (1985).

The Senate's ratification of the treaty with a reservation to Article 9(4) raised doubts about whether the British would sign the revised treaty. In addition to the strong business opposition in the United Kingdom to the reservation, there was concern over the growing cost of a retroactive refund to U.S. investors of the British Advance Corporation Tax, which the proposed treaty provided.[5] Not surprisingly, the British requested additional concessions for the Senate's refusal to prohibit WWCR[6] and the Executive branch entered into further negotiations with the United Kingdom. To induce the British to enter into the treaty with the Senate reservation and to compensate them for the states' use of WWCR, the Executive branch made concessions to the British in other provisions of the treaty.[7] These changes were reflected in

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[5] Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Report of the Committee on Foreign Relations, United States Senate on Executive Q, 96th Cong., 1st Sess., p. 47 (June 15, 1979). It was estimated that the retroactive refund would cost over $500 million through 1979. *Id.*

[6] According to Donald C. Lubick, Assistant Secretary for Tax Policy, "it was reasonable to expect the British to request some additional concession for the loss of the benefits of Article 9(4) . . . " *Id.* at 46.

[7] Donald C. Lubick, Assistant Secretary for Tax Policy, stated that "The British authorities view some of the provisions of the Third Protocol (particularly the North Sea permanent establishment rules) as a concession for the deletion of Article 9(4)." *Id.* at 46. The British Treasury Chief Secretary stated upon adoption of the Treaty: "the United Kingdom, recognizing the

the Third Protocol to the Treaty. As the Senate prepared to vote on the Third Protocol, it understood that it faced the following policy choice: if the treaty were to be approved, there could be no prohibition on WWCR; with such a prohibition, the treaty would not be ratified.[8] The Senate ratified the revised treaty with no prohibition on the states' use of WWCR by voting unanimously in favor of the Third Protocol. The Report of the Senate Foreign Relations Committee leaves no doubt that both the United States and the United Kingdom interpreted the treaty as authorizing the use of WWCR:[9]

> "Under the protocol, political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions, and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions (Article 24)."

California's use of WWCR is clearly within the bounds of this authorization because it does not violate the treaty's nondiscrimination clause, nor does either Petitioner allege such a violation.

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difficult constitutional problem in the United States which the application of Article 9(4) to individual State taxes posed and the *compensatory offer* which the United States has made, has acquiesced in the Senate reservation but has done so only with the greatest reluctance." Quoted in Kane, James M., "International Tax Treaties and State Taxation: Can the Federal Government Speak with One Voice?", 10 Virginia Tax Review 765, 781 (1991) (emphasis added).

[8] See 125 Cong. Rec. 17427-34 (July 8, 1979).

[9] *Supra* note 5 at 5.

Notwithstanding the unambiguous statements made by officials in both the United States and the United Kingdom that they understood the treaty as authorizing WWCR, and despite the United States "paying" for WWCR by making further concessions to the British, Petitioners would prefer an explicit statement authorizing WWCR in the body of the treaty. This requirement would impose a near impossible standard because neither the Senate nor the entire Congress is in the business of expressly reaffirming state taxing powers and there was no reason to start doing so in the U.S.-U.K. treaty.

First, the British obviously had no reason to demand such a statement. Neither, however, did the states. The whole debate over Article 9(4) proceeded on the assumption that the states had the right to impose WWCR unless otherwise restricted by the treaty (or federal legislation). Second, no tax treaty before or after the U.K. treaty has ever reaffirmed a state taxing power. Considerations of fiscal federalism have removed such powers from the purview of tax treaties. It would have been unprecedented for a tax treaty to have provided authorization for WWCR (or, for that matter, to provide for any other similar feature of state taxation). Third, an explicit provision in the U.K. treaty authorizing WWCR would have raised a negative inference about the constitutionality of other aspects of a state's tax regime, such as the taxation of foreign source dividends.

Nor do the recent cases of this Court demand that the treaty contain an express affirmation of WWCR. For example, the present case presents a more compelling situation than did *Wardair Canada, Inc. v. Florida Dept. of Revenue*, 477 U.S. 1 (1986) for finding that "the Federal

Government has affirmatively acted, rather than remained silent, with respect to the power of the States to tax . . . and thus that the case does not call for dormant foreign commerce Clause analysis at all." *Id.* at 9. *Wardair* upheld Florida's excise tax on fuel purchased by a Canadian airline for use exclusively in foreign commerce. In *Wardair*, the taxpayer argued that there was a federal policy to exempt the purchase of such fuel and that the Florida tax interfered with the government's ability to speak with one voice.

In support of its position, Wardair cited the Chicago Convention on International Civil Aviation, which precluded the imposition of local taxes on fuel only when the fuel was already on board an aircraft on arrival and retained on board on leaving; the Convention did not address the taxation of fuel purchased locally after arrival. *Id.* at 10. The Court held:

> "that the negative implications of this provision support recognizing Florida's power to tax; certainly, the provision demonstrates the international community's awareness of the problem of state and local taxation of international air travel, specifically aviation fuel, and represents a decision by the parties to that Convention to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority." *Id.* at 10.

The facts in *Barclays* present an even stronger case in favor of upholding the California tax than did the facts in *Wardair* for upholding the Florida tax. The exhaustive debate over Article 9(4) in the U.S.-U.K. treaty, the earlier

legislative attempts to deal with WWCR, and the reservation by the Executive branch to the 1963 and 1977 OECD Model Treaty clause[10] that would have had the effect of prohibiting state use of WWCR, demonstrate the international community's long-standing awareness of the problem. The Senate's reservation, combined with the concessions made to the United Kingdom, represent a decision by the parties to address the problem by preserving the states' power to tax. Even before *Wardair*, the Court recognized that where there has been ample debate over a tax issue, Congress' preservation of the status quo by refusing repeatedly to adopt legislation is support for concluding that Congress has acquiesced in the *status quo*.[11]

There are other strong parallels with *Wardair*. In *Wardair*, the Court said:

> "[m]ost strikingly as it relates to the case before us, the U.S.-Canadian Agreement itself limits the tax exemption to be afforded to foreign air carriers to 'national duties and charges.' Taxation by political subdivisions of either the United States or Canada are not mentioned, an

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[10] 1963 and 1977 OECD Model Income Tax Treaties and Commentaries: A Comparative Presentation (1987), at 16-17.

[11] See *Bob Jones University v. United States*, 461 U.S. 574, 600 (1983). The only difference between *Wardair* and *Barclays* is that in the former there was a provision precluding some local taxation of fuel whereas in the latter the prohibition is more general in that a state tax cannot be discriminatory. But this difference is irrelevant because the entire debate over WWCR leaves no doubt that the treaty was intended to permit the continued state use of WWCR.

> omission which must be understood as representing a policy choice by the contracting parties . . . ". *Wardair*, at 11.

Article 9(4) of the U.S.-U.K. treaty, similar to the U.S.-Canadian agreement, speaks only to national taxes. Taxation by political subdivisions of the United States is not mentioned in the U.S.-U.K. tax treaty, an omission that, in the context of the robust debate over Article 9(4), represents a clear, bargained for, policy choice by the contracting parties.

In *Wardair* the Court concluded that

> "[w]hat all of this makes abundantly clear is that the Federal Government has not remained silent with regard to the question whether States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By negative implication arising out of more than seventy agreements entered into since the Chicago Convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. Again, in the U.S.-Canadian agreement only 'national' charges are barred, and we presume that drafters from two federalist nations understood this as representing a choice not to preclude local taxation." *Id.* at 12.

Obviously, the debate over Article 9(4) and the Senate reservation represents a similar choice not to preclude the use of WWCR by the states. And, as was true in *Wardair*, in all the treaties negotiated since the U.S.-U.K.

treaty – more than 20 of which have already been signed[12] – the United States has never tried to impose any restrictions on the states' use of WWCR. The U.S.-U.K. tax treaty in particular, and the entire 25 year debate over WWCR starting in the early to mid 1960s,[13] would hardly qualify as Congressional silence. To the contrary, there has been a strident and contentious debate over whether to curtail WWCR.

The legislative history of the U.S.-U.K. treaty demonstrates what the expectations of the parties were. Accordingly, there is no need for the Court to address whether, in the absence of the U.S.-U.K. treaty, the foreign commerce clause would invalidate California's tax. "It would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted, and to apply it in such a way as to reverse the policy that the Federal Government has elected to follow." *Wardair*, at 12. "[T]he Federal Government is entitled in its wisdom to act to permit the States varying degrees of regulatory authority." *Id.*

To be sure, some former officials in the Executive branch have challenged the wisdom of the Legislative branch in permitting worldwide combined reporting. They pressed their concerns through press releases, speeches, *amicus* briefs, letters, political suasion, and attempts to pass legislation. They did not, however,

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[12] See Tax Analysts, WORLDWIDE TAX TREATY INDEX, May 1993, at 85-92; 8 TAX NOTES INT'L, 36 (January 3, 1994).

[13] The debate can be marked as either starting with H.R. Rep. No. 1480, 88th Cong. 2nd Sess. (Willis Committee report) in 1964 or with the introduction of H.R. 11798 in 1965.

attempt again to use the treaty mechanism to prohibit WWCR because they recognized that the Senate would not ratify any treaty containing such a provision.[14]

Consistent with *Wardair*, these Executive branch complaints deserve no legal weight. They carry even less weight than a Resolution adopted by the International Civil Aviation Organization, which the taxpayer cited in *Wardair* in support of its position that the Florida tax should be struck down under the dormant foreign commerce clause. The Court characterized the resolution as "an international aspiration on the one hand to eliminate all impediments to foreign air travel . . . ". *Wardair* at 10. The Court described the Resolution as "formally merely the work product of an international organization of which the United States is a member; it has not been specifically endorsed, let alone signed, entered into, agreed upon, approved, or passed by either the Executive or Legislative Branch of the Federal Government. In other words, no action has been taken to give the Resolution the force of law."[15] *A fortiori*, complaints by former officials in the Executive branch that do not even rise to the level of an International Resolution should not carry any more authority than the Resolution did in *Wardair*. Complaints about WWCR may represent "aspirations" but

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[14] Statement of Donald C. Lubick regarding the United States Model Tax Treaty, Hearings before the Committee on Foreign Relations, United States Senate, 96th Cong., 1st Sess. (June 6, 1979), p. 112.

[15] *Id.* at 11. The closest parallel to the Resolution is the OECD Model Tax Treaty. The United States, however, has taken a reservation to that part of the Model that would have applied to subnational taxes. See *supra* note 10.

until acted upon by the Legislative branch through a treaty or legislation remain just that – aspirations.

Itel Containers International Corp. v. Huddleston, 113 S. Ct. 1095 (1993), lends yet additional support to California's position. In *Itel*, the federal government had adopted various conventions, statutes, and regulations, restricting the ability of the states to tax international cargo containers in defined circumstances. State taxes collected in connection with the importation of cargo containers were also prohibited. The sales tax at issue in *Itel* did not fall within those proscriptions, "and the most rational inference to be drawn is that [the Tennessee sales tax], one quite distinct from the general class of import duties, is permitted." *Id.* at 1105. *Barclays* presents a much easier case than *Itel*; there is no proscription against WWCR for reasons that are well documented. WWCR does not fall within any of Article 9(4)'s constraints on WWCR, which apply only to the United States and the United Kingdom,[16] because of the bargain struck between the two countries. Moreover, *Barclays* is not a situation in which there is "congressional authorization for [WWCR] in congressional silence."[17] The vociferous debate over Article 9(4) is hardly tantamount to Congressional silence.

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[16] See *supra* note 2.

[17] *Itel* at 1110 (Blackmun, J., dissenting).

CONCLUSION

The U.S.-U.K. treaty was understood by the signatories as permitting WWCR. The Court's recent decisions in *Wardair* and *Itel* merely underscore that conclusion. Accordingly, this Court should affirm the judgments below.

Respectfully submitted,

JONATHAN P. HIATT*
1313 L. St., N.W.
Washington, D.C. 20005
(202) 898-3200

*Counsel of Record for *Amicus Curiae* Citizens for Tax Justice

Of Counsel:

PROFESSOR RICHARD POMP
University of Connecticut
School of Law
65 Elizabeth Street
Hartford, CT 06105-2290
(203) 241-4694

PROFESSOR OLIVER OLDMAN
Harvard Law School
1563 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4622

PROFESSOR MICHAEL MCINTYRE
Wayne State University Law School
468 West Ferry Mall
Detroit, MI 48202
(313) 577-3944

January 19, 1994

Nos. 92-1384 and 92-1839

FILED
JAN 19 1994
OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
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Respondent.

COLGATE-PALMOLIVE COMPANY,

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v.

FRANCHISE TAX BOARD
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeals Of The State Of California In And For The Third Appellate District

AMICUS CURIAE BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

ALAN H. FRIEDMAN*
General Counsel

PAULL MINES
Counsel
Multistate Tax Commission
444 No. Capitol St., N.W. Suite 425
Washington, D.C. 20001
(202) 624-8699
*Counsel of Record

January 19, 1994

BEST AVAILABLE COPY

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

Of Counsel:

PROFESSOR RICHARD POMP
University of Connecticut
School of Law
65 Elizabeth Street
Hartford, CT 06105-2290
(203) 241-4694

PROFESSOR OLIVER OLDMAN
Harvard Law School
1563 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4622

PROFESSOR MICHAEL MCINTYRE
Wayne State University Law School
468 West Ferry Mall
Detroit, MI 48202
(313) 577-3944

QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is pre-empted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

QUESTIONS PRESENTED – Continued

In its *Amicus Curiae* Brief, the Multistate Tax Commission shall address only Questions 1 and 2 of the Questions Presented.[1]

[1] The Multistate Tax Commission has received consent from all parties to file this brief and will file written confirmation of those consents with the Clerk of the Court.

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AMICUS CURIAE BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

STATEMENT OF INTEREST OF AMICUS CURIAE MULTISTATE TAX COMMISSION

The Multistate Tax Commission ("MTC" or "Commission") is the official administrative agency of the Multistate Tax Compact ("Compact"). Currently, the Compact has been entered into by 19 states and the District of Columbia as full members; and 13 additional states have joined the Commission as associate members.[1] The stated purposes of the Compact are to:

> 1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.
>
> 2. Promote uniformity or compatibility in significant components of tax systems.
>
> 3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.
>
> 4. Avoid duplicative taxation.

As reflected by these four basic principles, the Commission possesses vital and continuing interest in those state tax issues that may radically affect the administration of state tax systems. The pending cases have that potential. The issues contained in these two cases strike close to the core of one of the Commission's overall responsibilities – to ensure that state tax systems are allowed to innovate and develop more sophisticated methods of taxing business activities conducted within their jurisdictions, and to adapt those systems in response to evolving social and economic conditions.

---

[1] The current full members are the states of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The associate members are the states of Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee and West Virginia. To the extent that any member state of the Commission files a separate brief in this case, this *amicus curiae* brief does not represent the position of said state or states in this case.

SUMMARY OF ARGUMENT

Petitioners seek to elevate the "squeaking" of foreign multinationals, the "bullying shouts" of a few foreign governments, and the occasional "whining" of a few ex-officials of the Executive branch to the federal government's "one voice". The Court is being asked to follow these voices, as if they were the calls of the Pied Piper. However, when all of the self-serving noise and clutter are filtered out, one clear message emerges: worldwide combined reporting (hereafter "WWCR") is consistent with and not in opposition to policies adopted by the federal government with respect to the state taxation of foreign commerce.

No need for a dormant foreign commerce clause analysis exists in the cases before the Court because the circumstances surrounding the Senate ratification of the U.S.-U.K. Tax Treaty demonstrate that both countries acquiesced to the states' uses of WWCR. In particular, the Senate's reservation to proposed Article 9(4) of the Treaty clearly establishes that California's WWCR does not violate the "one voice" prong of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). Since this aspect of the "one voice" issue has been extensively addressed in the Brief of Respondent, the Commission will not repeat it here, but will deal primarily with the dormant federal commerce clause issue that is reached if the Court hears voices other than those expressed by Respondent and its *amici*.

Worldwide combined reporting for state tax purposes greatly reduces the opportunity for tax planning and tax avoidance with regard to international business activities conducted by domestic or foreign-based taxpayers. WWCR addresses more effectively than any arm's length or separate accounting method the taxation of income derived by a unitary business from international transactions, regardless of their operating in or through the various tax havens. This method of accounting (which its detractors often intentionally mislabel a "tax") is a product of our federal system. It was conceived, developed and advanced by the states to maturity over the past 40 years or so. The teaching of *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) suggests that it be left to

Congress to advance or limit the states' sovereignty in this area.

Even applying the test in *Japan Line*, WWCR should be upheld. More fundamentally, the *Japan Line* analysis is not appropriate in a global economy. To the extent that *Japan Line*'s rationale has survived subsequent decisions of the Court, it is clearly not properly applied outside the context of a tax, such as a property tax, for which no existing pattern or practice of eliminating double taxation exists. The Court's decisions in *Wardair Canada, Inc. v. Florida Dep't. of Revenue*, 477 U.S. 1 (1986) and *Itel Containers International Corp. v. Huddleston*, U.S. ___, 113 S.Ct. 1095 (1993) have all but overruled key holdings of *Japan Line*.

At issue in both cases is the use of the same type of accounting method, worldwide combined reporting. While all of the arguments that are set forth by the Commission are specifically addressed to Petitioner Barclays, with no specific mention of Petitioner Colgate-Palmolive Co., a very critical relationship exists between the issues in the two pending cases. If this Court were to prohibit WWCR in the case of *Barclays*, then, as a political matter, state legislatures will find it nearly impossible to apply WWCR to U.S.-based multinationals. A decision in favor of Petitioner Barclays under the foreign commerce clause (U.S. CONST. ART. I, § 8, cl. 3) will be tantamount to overruling the result in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

ARGUMENT

I. THE DORMANT FOREIGN COMMERCE CLAUSE DOES NOT PROHIBIT WORLDWIDE COMBINED REPORTING

A. The Dormant Foreign Commerce Clause Analysis Fashioned in *Japan Line* is Reminiscent of the Discredited *Cooley* Doctrine and is Unworkable.

The Court's dormant foreign clause analysis as formulated in *Japan Line* is reminiscent of the so-called *Cooley* doctrine, set forth in *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851). This similarity is not surprising because in both cases

the Court was struggling with the same issue: when does a state's action unconstitutionally impact on multijurisdictional economic activity. In *Cooley*, the Court held that the states could not regulate those aspects of interstate commerce that were so national in character that a single, uniform rule was necessary. *Id.* at 319. To paraphrase *Cooley* using the language of *Japan Line*, state regulations would be unconstitutional if they would "impair federal uniformity in an area where federal uniformity is essential." *Japan Line*, 441 U.S. at 448.

Over time, the *Cooley* doctrine proved unworkable for reasons that do not augur well for the Court's current formulation of dormant foreign commerce clause analysis. In the comparatively undeveloped U.S. economy of 1851, with a primitive transportation and communication infrastructure, there was less interdependency between the local and national economy. In this relatively uncomplicated era, the *Cooley* doctrine must have seemed manageable. As the country developed, however, the frequency of cross-border activities increased exponentially, and the line between local and interstate commerce became less distinct. Almost any state regulation had some impact on interstate commerce. The courts found it difficult, if not impossible, to determine which areas were, by their nature, inherently national.

According to a leading constitutional casebook, "the Court is not particularly well-suited for determining whether a given problem 'requires' a national solution as opposed to treatment tailored to local conditions,"[2] a sentiment that the Court itself has expressed in the context of the dormant foreign commerce clause. See *Container Corp. of America*, 463 U.S. 159, 194, 196. Because of the difficulty of identifying inherently national areas of interstate commerce, a subsequent doctrine, related to the *Cooley* doctrine developed. This doctrine required the Courts to distinguish between the constitutional "indirect" regulation of commerce and unconstitutional "direct" regulation.

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[2] DAVID CRUMP, ET AL., CASES AND MATERIALS ON CONSTITUTIONAL LAW 195 (1989).

That distinction was also criticized as being too mechanical and conclusory.[3]

Eventually, the earlier doctrines were discarded and "the tangled underbrush of past cases" was cleared. *Miller Bros. v. State of Maryland*, 347 U.S. 340, 344 (1954). The modern domestic dormant commerce clause analysis is now embodied in the four tests set forth in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1974). In the domestic situation, a tax will be upheld if it: is applied to an activity with a substantial nexus with the taxing state; is fairly apportioned; does not discriminate against interstate commerce; and is fairly related to the services provided by the taxing state. *Id.* at 279. For purposes of the interstate commerce clause, *Complete Auto* abandoned any attempt to determine the need for federal uniformity or the need for the government to speak with one voice.

The same economic forces that undermined the *Cooley* doctrine and its progeny domestically are still at work internationally, undermining *Japan Line*. As the world's economies become more interdependent, state regulations and taxes now increasingly impact foreign commerce as well as interstate commerce. State corporate takeover legislation, plant closing laws, right to work laws, policies on resource extraction, governmental procurement preferences, environmental, product liability, and antitrust regulations have a global impact through interlinked trade and investment ties. Environmental issues such as acid rain or global warming demonstrate that the economic and social welfare of individuals in any political jurisdiction are inextricably linked to the actions and interests of individuals living elsewhere. For example, a state such as California that has adopted pollution control and automobile emission standards more stringent than federal law has an impact on cars manufactured all around the globe.

As the world of *Cooley* evolved into the global marketplace, the role of state and local government has also evolved. "[S]ubnational governments have traditionally served as valuable innovators and incubators of policy ideas in many

[3] GERALD GUNTHER, CONSTITUTIONAL LAW 242 (1985).

different fields. The central difference now is the extension of this function to the foreign policy arena. . . . "[4] National borders have now become as porous as state borders. All of the examples noted above raise possible violations of the dormant foreign commerce clause. To sort through the panoply of state laws to decide which ones impact on the need for national uniformity is to sink into the *Cooley* quagmire.

B. The Federal Government Does Not Speak with One Voice on the Issue of WWCR Nor Does the Federal Government Consider Such Uniformity Essential

1. No Weight Should be Given to Complaints of Foreign Governments About WWCR

Japan Line takes the position that a state taxing scheme violates the dormant foreign commerce clause if it impairs federal uniformity in an area where federal uniformity is essential and if it prevents the federal government from speaking with one voice in international trade. *Container*, 463 U.S. at 193. In support of their assertion that WWCR runs afoul of the "one voice" metaphor, Petitioners cite the complaints of other countries against WWCR. These complaints are simply evidence of the success of WWCR in controlling tax avoidance by foreign-based multinationals and should be given no weight in assessing the constitutionality of WWCR.

When multinational firms began operating extensively in California during the 1960's and early 1970's, the state faced

[4] JOHN M. KLINE, UNITED STATES' FEDERALISM AND FOREIGN POLICY, IN STATES AND PROVINCES IN THE INTERNATIONAL ECONOMY, eds., Douglas M. Brown and Earl H. Fry (1993), 225. As a another illustration of the world's linked destinies, the European Community was particularly concerned with California's 1990 debate over Proposition 128, which would have imposed limits on the pesticide content of food that differed from federal standards. The EEC sent an "aide memoire" to the U.S. State Department, expressing concern that Proposition 128 could be "a means of arbitrary discrimination or a disguised restriction on trade, thereby unjustifiably increasing fragmentation of the U.S. market and adversely affecting international trade." *Id.* 219-20.

two policy options. It could continue to apply formulary apportionment and combined reporting to unitary businesses operating domestically but switch to the federal system of separate entity accounting and source rules for unitary businesses operating internationally. Or it could apply its formula apportionment statute (including combined reporting for unitary businesses of multiple corporations) to California members of all unitary businesses, regardless of whether those businesses operated internationally and regardless of where they were incorporated. California chose the second option. As more worldwide businesses were attracted to California, the state's application of what became known as worldwide combined reporting naturally occurred more often and created more notice.

The second option was fully consistent with California's domestic approach. The same reasons that led California and many states to use formulary apportionment and combined reporting for unitary businesses operating domestically applied equally, if not more strongly, in an international setting. Formulary apportionment and combined reporting eliminate the opportunities to avoid tax through the use of transfer prices and tax havens – opportunities that are particularly serious in an international setting.[5] One of the premises of the California approach in the domestic setting was that the tax paid by a unitary business should not be a function of the way it is organized on paper; California had no good reason to reject that premise just because part of the unitary business was conducted abroad or just because a corporation filed its incorporation papers abroad. WWCR merely extends California's domestic approach, based on substance over form, across national boundaries.

To implement its system internationally in a world marked by tax havens and great diversity in taxing rules, the federal

[5] Michael J. McIntyre, Design of a National Formulary Apportionment Tax System, in Proceedings of the Nat'l. Tax Ass'n/Tax Inst. of Am. 84th An. Conf. at 118 (November 1991).

government has had to develop source rules,[6] police transfer prices, and adopt anti-tax haven measures. The difficulties the IRS had, and continues to have, in policing transfer prices were well-known and it was doubtful that a state could independently administer an arm's length standard.[7] Subsequent events have borne out these fears.

Faced with these two choices, it is entirely understandable why California opted for WWCR. WWCR eliminates the need to police transfer prices, generally does away with source of income rules, and undercuts the use of tax havens. Tax planning that minimizes the federal income tax is typically useless under WWCR. Consequently, after WWCR was adopted, corporations able to pay no federal income tax now found themselves paying California tax, a situation that a foreign corporation or country not familiar with the federalist structure of the United States might not fully understand or appreciate.[8]

Certainly banks such as Barclays, with offices in some of the best-known tax havens of the world – Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Gibraltar, Hong

[6] Source rules serve two distinct purposes. First, they serve a jurisdictional purpose in that foreigners are generally taxed on only U.S. source income. Second, they determine how much of a credit a U.S. taxpayer will receive for foreign income taxes imposed on foreign source income. For an exhaustive treatment, see Michael J. McIntyre, The International Income Tax Rules of the United States, ch. 4(1989).

All the attention focused on transfer pricing problems has overshadowed a major weakness in the federal system: the need to develop a set of workable source rules that can be easily administered, that can not be manipulated by the taxpayer, that reflect some acceptable notion about economic nexus, and that assign income to countries inclined to tax it. See *id.* at 3-66 - 3-70. Formulary apportionment greatly reduces the need for source rules.

[7] The practical impossibility for even the federal government of enforcing the arm's-length system is well illustrated by the I.R.S.'s recent loss of an effort to compel Chevron Corporation to label 1.3 million pages of documents it turned over to the government in a transfer pricing case. *Chevron Not Required to Label 1.3 Million Pages Turned Over to IRS*, 2 BNA Tax Management Transfer Pricing Report 135 (July 7, 1993).

[8] For an early example of where a U.K. corporation was able to pay no federal tax but nonetheless had to pay a state tax under formulary apportionment, see *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924).

Kong, Isle of Man, Nauru, Netherlands Antilles, New Hebrides, Singapore, Turks and Caicos, Virgin Islands[9] – have much of their international tax planning nullified under WWCR. Complaints about WWCR may be nothing more than a protest against an approach that minimizes the benefits of orthodox tax avoidance techniques such as the use of transfer pricing and tax havens and results in the payment of a state tax even where no federal tax is due. For example, Barclays Bank International, Ltd. owed a California tax even though its California operations were conducted at a loss under the taxpayer's arm's length calculations.[10]

Complaints from foreign countries are neither unprecedented in the tax area nor limited to state taxation. Some foreign countries have also complained about the new transfer pricing regulations promulgated by the I.R.S.[11] Just as the lack of complaints about a state tax department may suggest a passive administration that is not aggressively countering tax avoidance, the existence of complaints may simply be a healthy sign of a well functioning tax system. A fact-intensive inquiry into the nature and motivation underlying the complaints paraded by the Petitioners is necessary before the Court can give them any significance for purposes of a dormant foreign commerce clause analysis.

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[9] See BARCLAYS INTERNATIONAL, A WORLD OF BANKING – LIST OF OFFICES NOVEMBER 1977 (1977) 4-5.

These countries are all described as tax havens in either ANTHONY S. GINSBERG, TAX HAVENS (1991), or HOYT L. BARBER, TAX HAVENS: HOW TO BANK, INVEST, AND DO BUSINESS – OFFSHORE AND TAX FREE (1993).

[10] See Letter from Barclays to British Inland Revenue of April 14, 1986 (Tr. record, Ex. 51-V).

[11] See OECD Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations Under U.S. Section 482 – Temporary and Proposed Regulations* (1993). Complaints by foreign governments may be raised as a courtesy to major taxpayers or industries or they may be initiated by the country itself. Most developed countries provide a credit to their taxpayers for income taxes paid to other jurisdictions. A country providing a credit has a financial stake in minimizing the tax burden imposed by other countries, especially if these other countries are not viewed as competing with it for investment.

2. No Weight Should be Given to the United Kingdom's Threats to Violate International Law

Complaints by the United Kingdom against WWCR are mentioned prominently by Petitioner Barclays because of the form in which they are embodied. The United Kingdom has threatened to deny certain benefits (the advance corporation tax, "ACT", credit) to corporations that have significant activity in a state using WWCR. The United Kingdom adopted enabling legislation in 1985,[12] but the Parliament had to give its specific approval before the retaliatory legislation could be triggered.

In 1986, British officials stated that they had not triggered the retaliatory legislation on the understanding that the United States would enact legislation abolishing WWCR before the end of the year.[13] The threat of "retaliation" was repeated two more times in 1986.[14] The threat was made again in 1988[15] and in 1993.[16] With the passage of California's legislation in 1993, discussed below, the threat has substantially been withdrawn.

These threats are the height of lawlessness and hypocrisy. In Article 10 of the U.S.-U.K. Tax Treaty, the United Kingdom agreed to provide the very ACT credits that it subsequently turned around and threatened to hold hostage in the political battle over WWCR.

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[12] Section 54 of the Finance Act of 1985, reenacted as §§ 812-815 of the Income and Corporations Taxes Act, 1988 (United Kingdom); Stephen E. Fiamma, *U.K. Retaliation Against Unitary Taxation*, 28 TAX NOTES 1137 (September 2, 1985).

[13] *British MPs United in Worldwide Unitary Method Retaliation Efforts*, 31 TAX NOTES 439 (May 5, 1986).

[14] Clive Holman, *MPs Threaten Retaliation Against US Unitary Tax*, FINANCIAL TIMES 6 (June 19, 1986); *Calling Britain's Bluff*, 300 THE ECONOMIST 65 (August 2, 1986).

[15] *Retaliatory Motion to Unitary Method Introduced in Parliament*, 38 TAX NOTES 592 (February 8, 1988).

[16] Sir Michael Grylls, MP, *UK Must Retaliate on CA Tax*, FINANCIAL TIMES 16 (May 6, 1993).

Further, its threats to violate international law[17] are in protest of WWCR, the very issue over which it received concessions during the negotiations over the treaty.[18] Such lawless action cannot be the type of justifiable retaliation by a foreign government that the Court was concerned about in *Container*. *Id.* at 194.

Apparently, the Congress agrees. The Congress has shown no interest either in counting the noses of those who have chimed in against WWCR or in genuflecting in the face of threats to violate international law.[19] Perhaps the Congress appreciates that as the economies of the world become more interlinked, state actions will inevitably raise some foreign protests. Some complaints are to be taken more seriously than others. As *Container* recognized, the nuances of U.S. foreign policy are much more the province of the Executive Branch and Congress than of this Court. *Id.* at 196. Despite complaints, Congress has refused for over twenty-five years to prohibit WWCR.[20] The Court should not now substitute its voice for that of the Congress.

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[17] There is no doubt that if the United Kingdom were to deny the ACT credits, the treaty would be violated. In describing the retaliatory legislation, Assistant Secretary (Tax Policy), J. Roger Mentz stated "its actual implementation would be a clear violation of the treaty." Hearing on Review of Unitary Method of Taxation, Before the Subcomm. on Taxation and Debt Management, Senate Committee on Finance, 81 (Statement of J. Roger Mentz, Asst. Secretary, Tax Policy) (September 29, 1986).

[18] Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Report of the Committee on Foreign Relations, United States Senate on Executive Q, 96th Cong. 1st Sess. at 46-7 (June 15, 1979).

[19] The United States could respond to a violation by the British of Article 10 of the treaty in numerous ways. The President could terminate the treaty; or, under domestic law, the President could double the U.S. tax rate on U.K. companies up to a maximum of 80%; or increase the effective tax rates on U.K. companies to equalize them with the U.K. tax rate on U.S. companies. See IRC §§ 891 and 896. All of these options are serious, which may explain why the U.K. has never implemented its threat.

[20] *See* Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Session. at 293-95 (statement of John S. Nolan, Counsel, on Behalf of Confederation of British Industry and the British National Comm. of the Int'l Chamber of Commerce) (March 31, 1980) for a detailed history (through 1980) of congressional consideration of, hearings on, and non-enactment of legislation that would have preempted WWCR and/or state taxation of foreign source income as it

3. The Executive Branch Does Not Speak for the Legislative Branch

Turning from international complaints about WWCR to domestic complaints, Petitioners remind us that former officials of the Executive branch of the federal government have been upset with the elimination of the anti-WWCR clause from the U.S.-U.K. treaty almost from the day that it was signed. Both Petitioners cite actions and statements from former Executive branch officials expressing their hostility to WWCR. But the federal government is not monolithic.[21] The issue of WWCR is not one in which the Constitution has given the President exclusive power. Power over foreign commerce is shared. The Legislative branch has the Constitutional power to regulate foreign commerce, the President has the Constitutional power to sign or veto legislation passed by the Congress, and the Congress has the Constitutional power to override a Presidential veto. The President has the Constitutional power to enter into treaties with foreign nations that might regulate foreign commerce, and the Senate has the Constitutional power to advice and consent on such treaties. This Constitutional distribution of powers does not give the President the power to preempt a state tax provision through press releases or letters.

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is defined by the federal government. Legislation to prohibit WWCR was introduced continuously through the 1980s in both houses and hearings were held at regular intervals. See *Hearing, supra* note 17. Preemptive legislation has been introduced at least as recently as late 1991. See S.1775, H.R. 2913, 102d Cong. 1st Sess.

[21] The Court has never suggested that the views of the Executive branch were to carry more weight than the views of the Legislative branch. In its dormant foreign commerce clause discussion in *Container*, the Court consistently refers to the "federal government," "federal policy," "the Executive Branch and Congress" and so forth. See *Container*, 463 U.S. at 193-196. The disproportionate emphasis placed by the Petitioners on the views of the Executive branch may reflect the Court's reference in *Container* to the lack of an *amicus curiae* brief from the Executive branch. The failure of the Executive branch to file an *amicus curiae* brief would undercut a claim that WWCR interferes with federal uniformity. The filing of such a brief, however, is merely one factor to be considered by the Court in applying a dormant foreign commerce clause analysis. *Compare Itel*, 113 S.Ct. 1095 *with Container*, 463 U.S. 159.

Otherwise, the constitutionality of WWCR could change every four years and would "emphasize transient results upon policies . . . and lose sight of enduring consequences upon the balanced power structure of our Republic." *Youngstown Co. v. Sawyer*, 343 U.S. 579, 634 (Jackson, J., concurring) (1952). Such a result would be contrary to our deeply held tradition of being a country that ascribes to the "rule of law." Fortunately, the foreign dormant commerce clause does not require that absurdity.

Understandably, the Petitioners would like to ignore the posture of the Legislative branch, which has always refused to interfere with WWCR. The Senate made its position clear at the time of the U.S.-U.K. tax treaty: "political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions, and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions (Article 24)."[22] The House has also expressed its position by refusing to adopt for the past 20 years bills that have been introduced that would affect WWCR.[23]

After more than two decades of debate, the Legislative branch has still refused to curtail the use of WWCR. Uniformity can hardly be characterized as "essential" if it is still lacking after all this time. Accordingly, California's use of WWCR cannot "impair federal uniformity in an area where federal uniformity is essential." *Container*, 463 U.S. at 193 (citing *Japan Line*, 441 U.S. at 448).

Finally, even a decision for Petitioners would not result in the government speaking with one voice because the Congress has indicated not only that federal uniformity is not essential but also that WWCR is permitted. The Court has, in similar contexts, recognized its limitations in imposing solutions on

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[22] *Report, supra* note 18, at 5.

[23] See Brief for Petitioner Barclays at 9.

issues best left to the political process.[24] "It may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.' "[25]

Furthermore, California's use of WWCR is not necessarily at odds with the actions of the Reagan administration, which is the last administration to articulate a comprehensive position on WWCR. In 1983, the Reagan administration appointed a Cabinet level working group, consisting of government officials, business representatives, and representatives of the state governments, to study the issue.[26] The Working Group recommended that the states voluntarily adopt a water's edge limitation on combined reporting. Secretary of the Treasury Regan's final report indicated that the Group would support restrictive federal legislation if the issue was not solved within a year of the report. But if the "states enact legislation . . . agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners . . . "[27]

California enacted water's edge legislation, but made it elective and imposed an election fee. This action appeased the Executive branch, which stated that "state legislative developments . . . go a long way toward resolving the difficult unitary tax issue" and "illustrate the successful operation of the

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[24] "The underlying [commerce clause issue] is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *Quill Corporation v. North Dakota*, 112 S. Ct. 1904, 1916 (1992). *Quill* involved another long-standing problem of state taxation: the sales taxation of mail order sales. Despite Congress' unwillingness to adopt a federal solution to this problem, the Court refused to impose its own solution, recognizing that "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens." [citations omitted]. *Id.*

[25] *Quill*, 112 S.Ct. at 1916 (citing *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 638 (1981) (White, J., concurring)).

[26] *New Unitary Approaches Mulled in Wake of Treasury Decision*, 21 Tax Notes 69-70 (October 3, 1983).

[27] Department of the Treasury, Office of the Secretary, Final Report of the Worldwide Unitary Taxation Working Group, iii (August, 1984).

Federal system."[28] The Executive branch pronounced "that restrictive Federal legislation is not warranted at this time."[29] Most recently, in 1993 California further amended its legislation, removing the election fee. California's current law satisfies the expectations of the Reagan administration.

With the election of President Clinton, the Executive branch may have shifted its voice. During the 1992 presidential campaign Governor Clinton stated " . . . a Clinton Administration will be pro-California in [the *Barclay's*] litigation."[30] Consistent with this position, the Solicitor General opposed the grant of *certiorari* in *Barclays*, citing California's recent legislative changes modifying WWCR for concluding that "[a] decision by this Court on the constitutional question posed in this case is . . . unnecessary to achieve adequate consistency in the Nation's regulation of foreign commerce, which California has striven to accomplish through its voluntary action." Brief of Solicitor General on Petition for *Writ of Certiorari* at 10. The Solicitor General also made it clear that federal uniformity is no longer essential. There has now been an "accommodation of state, national, and international interests," *id.* at 10. As of 1994, it appears that the voice of the Executive branch is more in harmony with the voice of the Legislative branch than at

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[28] See *Hearing*, *supra* note 17 at 71.

[29] *Id.*

[30] John Turro, *Clinton Administration Expected to Support California in Barclays Bank Unitary Case*, 4 State Tax Notes 717-718 (March 29, 1993). This position was consistent with the President's promise to collect $45 billion of additional tax revenue over four years by "cracking down on foreign companies that prosper here and manipulate tax laws to their advantage." Governor Bill Clinton, *Putting People First: A National Economic Strategy for America*, 4, 22 (1992). It was widely believed that this revenue loss was attributed to transfer pricing abuses. For example, a former Commissioner of the Internal Revenue Service testified that "foreign controlled companies have adopted transfer pricing and other practices that may significantly understate their U.S. income tax liabilities," and that the IRS believes "the shortfall is substantial," with the "U.S. Government . . . being short-changed billions of dollars annually." Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings before Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 2d Sess., July 10, 12, 1990, pp. 72, 73 (Statement of Fred T. Goldberg, Commissioner of the IRS). Estimates of the annual federal revenue loss from transfer pricing abuses is as high as $30 billion. *Id.*, at 262 (Statement of Rep. J. J. Pickle).

any other time in the debate over WWCR. Also, the retaliatory threat of the United Kingdom to deny treaty benefits to U.S. corporations has subsided.[31]

C. No Unconstitutional Double Taxation Exists

Under *Japan Line*, a tax is constitutionally suspect if it inevitably results in double taxation. In *Japan Line*, the same property was taxed by both Japan and California, with no established means of mitigating the overlapping assertions of taxing jurisdiction. The meaning of objectionable double taxation was obvious in *Japan Line*: two taxes on the same property with no relief mechanism. In a world in which both national and subnational governments impose income taxes, and where a long-standing custom and pattern of relief mechanisms exist internationally, the concept of objectionable double taxation is less evident. The Court in *Container* appreciated the difference between property taxes and income taxes and properly dismissed the double taxation argument in that case. Because Petitioner Barclays attempts to reopen that argument, it is worthwhile to expand on why there is no objectionable double taxation in the present case.

As this Court has recognized, double taxation already exists in the purely domestic U.S. situation. In *Mobil Oil v. Vermont*, 445 U.S. 425, 448 (1980), the Court recognized that

> "[c]oncurrent federal and state taxation of income, of course, is a well-established norm. *Absent some explicit directive from Congress*, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." (Emphasis added).

A corporation's income is taxed by both the federal government and the states.[32] This type of double taxation is above constitutional challenge. In other federalist countries, such as Canada, this

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[31] See Brief of the Government of the United Kingdom as *Amicus Curiae* in Support of Petitioner at 21-22.

[32] The double taxation from the concurrent taxation by the United States and the states is mitigated because state income taxes are deductible in calculating the federal income tax. A few states even allow a deduction for the federal income tax in calculating the state income tax. See Richard Pomp, *The Illogical Deduction for Income Taxes Paid to Other States*, 42 Tax Law Rev. 419 (1987); Jerome R.

same pattern of unobjectionable double taxation exists between the national government and the subnational governments.

When a corporation resident in one country (the country of residence) earns income from another country (the source country), problems of double taxation can arise if no relief mechanism is provided. But in the case of income taxes, that problem tends not to occur. The custom and international practice is that the country of residence assumes the responsibility for eliminating the double taxation.[33] Most countries discharge this responsibility by either exempting foreign income (or categories thereof) or by providing a credit for income taxes paid to the source country.[34]

> "The effect of the foreign tax credit is that when the foreign tax rate is lower than the United States rate . . . a tax is paid to the United States at a rate equal to the excess of the United States rate over the foreign rate. When the foreign rate equals or exceeds the United States rate, the credit cancels United States tax liability. In short, the credit generally operates to reduce the effective over-all rate of tax to the higher of the foreign or the United States rate *and double taxation is eliminated because, in effect, only one tax is paid at the higher of the two rates.*"[35]

The credit does not eliminate the double taxation that results from the concurrent taxation by a national government and its subnational governments. This type of double taxation is the norm and outside the goal of the credit, regardless of whether a subnational government is taxing more or less income than what the national government is taxing.

For example, suppose P, a corporation, earns $100 in the source country and pays an income tax to the source country of

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Hellerstein and Walter J. Hellerstein, State Taxation I: Corporate Income and Franchise Taxes (1993), 7-10.

[33] See U.S. Model Tax Treaty, Art. 23; OECD Model Tax Treaty, Art. 23.

[34] Nearly one-third of the OECD countries exempt foreign dividends received from other OECD countries. The remainder provide a foreign tax credit. See OECD, Taxing Profits in a Global Economy: Domestic and International Issues at 63 (1991).

[35] Elizabeth Owens, The Foreign Tax Credit 3 (1961) (emphasis added).

$20. Assume the country of residence also imposes a tax of $30 on this same income. Without the credit (or some other relief measure), double taxation would result because P would be paying two taxes on the same item of income. If the country of residence chooses to discharge its responsibility for relieving double taxation through the use of a credit, it would reduce the $30 of tax otherwise owed to it by the $20 paid by P to the country of source, for a net tax of $10. P pays the same amount of tax that it would have paid if all of the income had been earned in the country of residence. Any subnational income tax in the country of residence would be in addition to the national taxes – the same result that occurs in a purely domestic situation.

Double taxation might occur if a subnational government in the country of residence is taxing income that is also subject to tax by a subnational government in the source country. Without any relief, there would be one level of national tax, as in the preceding example, and two levels of subnational taxes. One way of dealing with this problem of double taxation by subnational governments, if it occurs, would be for the subnational government in the country of residence to provide a credit for the income tax of the subnational government in the country of source. The responsibility of relieving subnational double taxation, however, has been viewed as the proper responsibility of the national government, which can easily address the problem by simply extending its tax credit to include foreign subnational income taxes.[36]

Some countries, such as the United States, Canada, and the United Kingdom, have unilaterally adopted foreign tax credits that extend to subnational income taxes.[37] Other countries that might not have done so unilaterally might do so by treaty. The OECD Model Tax Treaty, for example, provides that if the country of residence chooses to relieve double taxation by a credit rather than

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[36] See *Container*, 463 U.S. at 191 n. 30.

[37] In the United States, see IRC Sec. 901(b) and Treas. Reg. § 1.901-2(g)(2); in Canada, see ITA, Sec. 126(7)(a),(b); in the United Kingdom, see ICTA of 1970, Sec. 498.

by exempting foreign income, the credit extends to subnational income taxes.[38]

Barclays is not disputing California's right to impose some kind of income tax. Barclays is therefore conceding that two legitimate levels of taxes can exist: the federal income tax and the state taxes. An objectionable double tax would occur only if California and a subnational U.K. government taxed the same income. But such double taxation cannot occur because subnational governments in the United Kingdom do not levy income taxes.[39] Even if such double taxation occurred, the responsibility for alleviating it would fall on the United Kingdom as the country of residence. The essence of Barclays' objections to WWCR reduces to the fact that it may pay more under that system than under the arm's length method. But that objection may speak more to weaknesses in the arm's length method than to defects in WWCR.[40]

Moreover, it is not inevitable that WWCR produces a higher tax than would arm's length or some alternative form of taxation. There are at least two situations in which a taxpayer will be better off under WWCR than under the U.S. rules. The first involves corporations operating at a loss. WWCR allows a taxpayer to include loss corporations that have no nexus with California to be included in the combined report of the unitary business. These losses will offset income of the other corporations. The result can be that less income enters the pre-apportionment tax base than would be true if California followed the federal rules.[41]

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[38] OECD Model Tax Treaty, Arts. 23B, 2(1).

[39] ANDREW W. DILNOT & J.A. KAY, TAX REFORM IN THE UNITED KINGDOM: THE RECENT EXPERIENCE, IN WORLD TAX REFORM, eds. M. Boskin and C. McLure (1990), 149-176.

[40] Residence countries that have chosen to address double taxation through the use of foreign tax credit often have complicated rules to prevent abuse or to further political goals. Complaints that Barclays might have about the British foreign tax credit are properly addressed to the British Inland Revenue and not this Court.

[41] To take a simple, straightforward example, consider a U.S. parent operating in California owning 100% of a foreign corporation, which operates abroad at a loss. Assume the U.S. parent has $100 of income and that the foreign subsidiary has $100 of losses. If the U.S. parent files a combined report with its foreign subsidiary, the $100 loss will offset the $100 gain and there will be no taxable income. By contrast under the federal rules, U.S. corporations cannot file consolidated returns with foreign corporations. The parent would be taxable by the United States on $100. If, however, the U.S. corporation were to operate abroad in the form of a branch, the foreign loss would be offset against its U.S. profits. Consequently, the choice between operating abroad as a branch or as a subsidiary has U.S. tax consequences. Under California's approach, however, the same amount of California tax would be due regardless of whether a branch or a subsidiary were used. The California method has the advantage of not making the tax a function of how a business is organized on paper. Put differently, the California fisc will not be affected by the form in which a business chooses to operate.

Second, under WWCR the apportionment percentage of the California taxpayer will reflect the payroll, property, and sales of all the members of the unitary business. The apportionment percentage of a unitary business that includes foreign corporations will likely be lower than under a water's edge approach where only U.S. corporations could be included in the combined report. The lower percentage may more than offset the increase in the pre-apportionment tax base resulting from including profitable foreign corporations.[42] Accordingly, there is no systemic bias in WWCR one way or the other.[43]

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[42] To illustrate, consider a U.S. parent that owns 100% of a foreign corporation. Assume the U.S. parent has $100 of taxable income and that its subsidiary also has $100 of taxable income. If only the parent is taxable by California under a water's edge approach, assume its apportionment factor is 25%, so that it would apportion $25 to California (25% X $100). Assume further that if the foreign subsidiary were included in a combined report, the apportionment factor would decline to 5%. In a combined report, the corporation would apportion $10 to California (5% X $200). The increase in taxable income from $100 to $200 is more than offset by the decline in the apportionment percentage from 25% to 5%.

[43] Petitioner Barclays' assertion that the "underlying economic assumption [of WWCR is] that the activity of the worldwide unitary business is equally profitable in all jurisdictions," Petitioner Barclays' Brief at 24, has been rejected by this Court, as well as by scholars. See Container, 463 U.S. at 182-83; Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, 60 TAX NOTES 1131, at 1140-1141 (August 23, 1993); and Eric J. Coffill, *Differences in Productivity and Profitability: A Response to Allegations of the Misattribution of Income in the Application of California's Worldwide Unitary Method*, 5 INT'L TAX & BUS. LAW. 246 (1987).

D. The Court Should Clarify that *Japan Line* does not Apply to Corporate Income Taxes

The globalization of the marketplace means that state tax systems will inevitably reach activities having international connections. As this case demonstrates, *Japan Line* invites endless quarrels between the states and the multinationals. If the Petitioners were to have their way, every complaint by a foreign country about a state tax can become a federal Constitutional issue. And such complaints can easily be orchestrated.

A principled distinction exists, however, between property taxes and income taxes. Unlike income taxes, there is no international custom or pattern requiring the country of residence to provide a credit for property taxes levied by other countries.[44] Moreover, Japan actually levied a property tax on the same containers that were taxed by California and did not provide a credit for foreign property taxes. *Japan Line*, 441 U.S. at 452. Consequently, double taxation existed in fact.

The recent decision in *Itel* suggests that the Court itself recognizes that *Japan Line* should not be applied if measures exist for relieving double taxation. In upholding Tennessee's sales tax on the proceeds from the lease of containers used in foreign commerce, the Court stated,

> "[f]urthermore, the foreign commerce clause cannot be interpreted to demand that a state refrain from taxing any business transaction that is also potentially subject to taxation by a foreign sovereign . . . [the Tennessee credit] reduces, if not eliminates, the risk of multiple international taxation . . . Absent a conflict with a 'consistent international practice [or] . . . federal policy,' *Container Corp.*, 463 U.S., at 190, the careful apportionment of a state tax on business transactions conducted within state borders does not create the substantial risk of international multiple taxation that implicates foreign commerce clause concerns. . . . "

Itel, 113 S.Ct. at 1104.

[44] The lack of a custom of relieving double taxation in the case of property taxes is not surprising; under the discarded "home port doctrine" there would not be multiple property taxes. Although the Court in *Japan Line* refused to rehabilitate the home port doctrine, 441 U.S. at 443, the result of the case is consistent with that doctrine.

The concerns the Court expressed about multiple taxation in *Japan Line* have long been addressed and remedied in the case of income taxes. At a minimum, *Japan Line* should be limited to situations of multiple taxation that the international community has not addressed.

E. *Itel* and *Wardair* Cast Doubt on the Continued Vitality of *Japan Line*

The reasoning of *Itel* and *Wardair* would have required a different outcome in *Japan Line*. *Japan Line* involved the Customs Convention on Containers, signed by both Japan and the United States. The relevant part of the Convention provided that " . . . containers temporarily imported are admitted free of 'all duties and taxes whatsoever chargeable by *reason of importation*.' " *Japan Line*, 441 U.S. at 452. In interpreting the same Convention, *Itel* makes it clear that the relevant inquiry is the reason a state imposes a tax and not the reason why the subject of the tax – the containers – are in the jurisdiction. *Itel*, 113 S. Ct. at 1100. The *Itel* Court held that the Convention prohibits only those taxes based on the act of importation itself. The Los Angeles property tax in *Japan Line* would presumably be upheld under this standard because it is not imposed on the act of importation nor is it any kind of import duty or custom duty.

Japan Line is also inconsistent with *Wardair*. In *Wardair*, the Court examined the Chicago Convention on International Civil Aviation, a Resolution by the International Civil Aviation Organization, and other bilateral agreements dealing with international aviation. None of these prohibited taxation of aviation fuel by political subdivisions, "an omission which must be understood as representing a policy choice by the contracting parties." *Wardair*, 477 U.S. at 11.

> "What all of this makes abundantly clear is that the federal government has not remained silent with

> regard to the question of whether states should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By negative implication arising out of more than 70 agreements entered into since the Chicago convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. . . . " *Id.* at 12.

By contrast, in *Japan Line* the Court characterized a convention authorizing an exemption only from duties and taxes chargeable by reason of importation, as "reflect[ing] a national policy to remove impediments to the use of containers . . . " *Japan Line*, 441 U.S. at 452. *Wardair* suggests that the Court in *Japan Line* should have inferred that the signatories had acquiesced in a property tax on containers.

From a broader perspective, *Japan Line* is an aberration. *Japan Line* was decided in 1979, just two years after the Court made clear in *Complete Auto* that it had abandoned any attempt at determining when a state tax interfered with national uniformity or imposed a direct burden on interstate commerce. Without much experience with the four tests in *Complete Auto*, perhaps the *Japan Line* Court was unwilling to abandon the old *Cooley*-type inquiries in the case of foreign commerce. The difficulty with that type of inquiry seemed to be recognized by 1983 when the Court in *Container* went to great lengths – properly so – to remove state income taxes from the *Japan Line* orbit. *Container* showed great sensitivity to the complexities that are resolved by the rational workings of WWCR. Dormant foreign commerce clause analysis is not rigorous enough to be used to annul basic taxing schemes such as WWCR. Subsequent experience with the *Complete Auto* tests should reassure the Court that the additional *Japan Line* tests are unnecessary in the case of income taxes.

II. PROHIBITING WWCR UNDER THE DORMANT FOREIGN COMMERCE CLAUSE WOULD UNDERCUT THE CONSTITUTIONAL PROTECTION OF FEDERALISM

This case presents a weak setting for the application of the dormant foreign commerce clause. The Court is not writing on a clean slate, as it has in other situations. See, e.g., *Kraft v. Iowa*, 112 S. Ct. 2365 (1992). The issue of WWCR comes to the Court with 25 years of history. In 1978, in the debate over the U.S.-U.K. tax treaty, Senator Church stated that "[f]or some ten years, Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty."[45] He noted that "[t]he original purpose for the Senate's role in the treaty process was to protect the interests of the several States in treaty matters. The framers feared that to give the executive branch of the Federal Government free rein in the treaty process would enable the President to ride roughshod over the States. We may have waited a while to see that fear confirmed, but that is exactly what article 9(4) of this treaty does. It demonstrates that the fears of the framers of our Constitution were well founded."[46]

Senator Church's understanding of the constitutional structure of the government was expanded upon by the Court a few years later:

> "Apart from the limitation on federal authority inherent in the delegated nature of Congress' Article I powers, the principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress. [footnote omitted]. . . . " In short, the Framers chose to rely on a federal system in which special restraints on federal power

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[45] 124 CONG. REC. Part 14, Senate pp. 18416. (June 22, 1978).

[46] *Id.* at 18417.

> over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power. . . . we are convinced that the fundamental limitation that the constitutional scheme imposes on the Commerce Clause to protect the 'States as States' is one of process rather than one of result. . . . the principal and basic limit on the federal commerce power is that inherent in all congressional action – the built-in restraints that our system provides through state participation in federal government action. The political process ensures that laws that unduly burden the States will not be promulgated."

Garcia, 469 U.S. at 550-52, 554, 556 (1985).

To date, the political process has ensured that the federal government would not impose constraints on WWCR, thereby recognizing that the power of taxation is an essential and indisputable attribute of state sovereignty. The curtailment of WWCR has come from the voluntary action of the states at the encouragement of the Executive Branch. As the Solicitor General stated, an "accommodation of state, national, and international interests"[47] has now been reached. That accommodation was over two decades in the making and should not be upset by this Court under a dormant foreign commerce clause analysis.

Considerations of federalism also caution against destroying the diversity of experimentation in the field of state taxation. As Justice Brandeis wrote,

> "There must be power in the States and the Nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs. . . . It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a

[47] Brief of Solicitor General on Petition for *Writ of Certiorari* at 10.

> laboratory; and try novel social and economic experiments without risk to the rest of the country."

New State Ice Co. v. Liebman, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). WWCR well illustrates Justice Brandeis' wisdom.

The states were forced early in this century to cope with the problem of taxing multijurisdictional activities; in response to this challenge, they designed formulary apportionment and combined reporting. As federal officials and their counterparts around the world are becoming increasingly disillusioned with the arm's length method, they are beginning to extol the virtues of WWCR. For example, at his confirmation hearings, the Undersecretary of the Treasury for International Affairs referred to formulary apportionment as the direction in which the world will have to move.[48] Indeed, WWCR has already been suggested for use by the United States, Canada, and Mexico in the taxation of corporations operating within the North American Free Trade Zone.[49] Examining the issue of formulary apportionment for use by the European Community, a person who would become Assistant Secretary of the Treasury wrote: "Formula apportionment provides a useful and fair approximation of geographic allocation of income. This approach helps to curb tax avoidance by making it difficult to shift income away from high-tax jurisdictions. Furthermore, if a Community-wide formula were adopted, then the potential for double taxation would be mitigated. Additionally, formula apportionment simplifies tax administration, because authorities no longer need to verify

[48] *Summers Says Formula Apportionment System Would Require Multilateral Move*, 52 BNA Daily Tax Report G-6 (March 19, 1993) at G-7. Summers earlier wrote that under the federal rules, multinational firms can move profits across borders by manipulating transfer prices and by altering their means of financing. "An alternative approach is to rely on formula apportionment, which obviates the need to locate a multinational's home country and eliminates the incentive to use transfer prices to manipulate tax liabilities." See Lawrence H. Summers, *Taxation in a Small World*, in Herbert Stein, ed, Tax Policy in the Twenty-First Century 64, at 69, 70, 71 (1988).

[49] McIntyre and McIntyre, Using NAFTA to Introduce Formulary Apportionment, 93 Tax Notes International 64-9 (April 5, 1993).

the transfer prices involved in separate accounting, a time-consuming and difficult process."[50]

At a recent international conference involving tax officials, academics, lawyers and OECD representatives, formulary apportionment was acknowledged as having a bad reputation, largely because of political reasons.[51] This same group of tax experts concluded that the " arm's length principle and formulary apportionment should not be seen as polar extremes . . . it is not clear where the arm's length principle ceases and formulary apportionment begins."[52] Indeed, in one of the ultimate ironies in this case, it has been reported that Barclays negotiated a transfer pricing agreement with the IRS based on formulary apportionment.[53] IRS officials have confirmed that they have completed an "advanced pricing agreement" with a foreign bank based on a three-factor formulary apportionment method employed on a worldwide basis.[54] Paradoxically, at a time when federal officials are looking to

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50 Alicia H. Munnell, *Taxation of Capital Income in a Global Economy: An Overview*, NEW ENGLAND ECONOMIC REVIEW 33, at 46 (September/October 1992). This article was written when Assistant Secretary of the Treasury for Economic Affairs Alicia H. Munnell was Senior Vice President and Director of Research for the Federal Reserve Bank of Boston. Her views are consistent with other scholars. See, for example, McIntyre, Harmonizing Direct Taxes in the EEC, 2 TAX NOTES INT'L 131 (1990); McIntyre, Harmonizing Direct Taxes on Business within the EEC, 2 TAX NOTES INT'L 341 (1990).

51 Brian J. Arnold and Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries*, 61 TAX NOTES 1377, at 1381(December 13, 1993).

52 *Id.*

53 John Turro, *IRS Grants Two APAs in Derivative Products Areas*, 4 TAX NOTES INT'L 959 (May 11, 1992); Gerald C. Shea, *APAs May Effectively Address Income and Expense Allocation Problems Faced by Global Trading Businesses*, 4 TAX NOTES INT'L 1022 (May 18, 1992).

54 Case example 2 in an Internal Revenue Service report on the Advanced Pricing Agreement program is "a U.S. branch of a foreign bank. The APA applied a *formulary allocation* of the net trading *profits* of the participants from their trading of derivative products on an integrated *worldwide basis*. The APA used a methodology with a *weighted three factor approach*." *See:* Robert Ackerman, et al., *The Advance Pricing Agreement (APA) Program: A Model Alternative Dispute Resolution Process*, 12 BNA DAILY REPORT FOR EXECUTIVES L-1 (January 19, 1994), at L-4 (emphasis added). (The authors are identified as staff members of the APA Program in the IRS Office of the Associate Chief Counsel (International)). *Id.*, at L-1.

WWCR as part of a solution to the dilemma of arm's length pricing, the states have succumbed to political pressures and have retrenched.

The current emphasis on reinventing government has led to a new appreciation of the contributions and impact the states have had on federal policies. The experience of the states with WWCR has helped expose the practical inefficiencies and limitations with the arm's length approach and has irrevocably altered the debate over transfer pricing issues.

Out of necessity, the states have built a better mousetrap than the federal government. This mousetrap cannot be avoided by mergers and acquisitions, reorganizations, by how a business is organized on paper, or by where incorporation papers are filed, or by the setting of artificial prices in transactions between related parties. The mousetrap catches those who would use tax havens, such as Bermuda, the Cayman Islands, the Isle of Man, Nauru, the Turks and Caicos, or the Virgin Islands. The mice that get caught will squeak – and they may even get their friends to squeak and make empty threats. But these complaints cannot rise to the level of Constitutional significance without the anomalous result that the better the mousetrap, the greater the chance that the courts will release the mice.

The multinational community has led a relentless political campaign against WWCR. These efforts have forced the states to adopt voluntary limits on WWCR. Not content with this political victory, Petitioners are asking this Court to seal the laboratory doors shut so that no state could ever resurrect the method again. In an era of diminishing resources, the states need the freedom to deal with ever more complex international transactions. If the state laboratories are to be permanently closed, there should be more compelling reasons than those presented by the Petitioners.

CONCLUSION

For the reasons stated above, Amicus Multistate Tax Commission urges the Court to affirm the decisions below.

Respectfully submitted,

ALAN H. FRIEDMAN*
PAULL MINES
Multistate Tax Commission
444 No. Capitol St., N.W.
Suite 425
Washington, D.C. 20001
(202) 624-8699

**Counsel of Record for Amicus Multistate Tax Commission*

Of Counsel:

PROFESSOR RICHARD POMP
University of Connecticut
School of Law
65 Elizabeth Street
Hartford, CT 06105-2290
(203) 241-4694

PROFESSOR OLIVER OLDMAN
Harvard Law School
1563 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4622

PROFESSOR MICHAEL MCINTYRE
Wayne State University Law School
468 West Ferry Mall
Detroit, MI 48202
(313) 577-3944

January 19, 1994

No. 92-1639

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1993

COLGATE-PALMOLIVE, CO.,
Petitioner,

vs.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California for the Third Appellate District

BRIEF OF AMICI CURIAE LITTON INDUSTRIES, INC. AND THE TIMES MIRROR COMPANY IN SUPPORT OF RESPONDENT

ERIC J. MISTICHELLI, ESQ.
Counsel of Record
JODY E. MUELLER, ESQ.
NIELSEN, MISTICHELLI,
PARRINELLO, MUELLER & NAYLOR
770 L Street, Suite 950
Sacramento, California 95814
(916) 446-6752
Attorneys for Amici Curiae

[illegible] B. McCORMICK, JR.
[illegible] M. CRAWFORD
[illegible], Inc.
[illegible] Ocean Drive
[illegible], California 92216

DEBRA A. GASTLER
The Times Mirror Company
Times Mirror Square
Los Angeles, California 90053

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No. 92-1839

IN THE
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OCTOBER TERM, 1993

COLGATE-PALMOLIVE, CO.,

Petitioner,

vs.

FRANCHISE TAX BOARD,
An Agency of the State of California,

Respondent.

INTEREST OF AMICUS CURIAE

Amici curiae Litton Industries, Inc. ("Litton") and The Times Mirror Company ("Times Mirror") are domestic (United States parented) multinational corporations involved in a variety of industries ("Amici"). Amici compete in a global marketplace against foreign and domestic-based corporate groups.

Litton is a technology company providing resource exploration services, industrial automation systems and advanced electronic and defense systems for North American

and world markets. Times Mirror is a California-based media and information company. Its publishing business is operated throughout the United States, Europe and the Far East.

The issue in this case is the constitutionality of *compulsory* worldwide combined reporting ("WWCR") for domestic-based corporations. This issue was decided in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) ("*Container*"). California changed its law in 1986 to permit all corporations to elect to file on either a WWCR or water's edge basis. Amici currently elect to have their California tax liability computed under WWCR because, like some other domestic-based corporations, they have concluded that it is competitively advantageous to continue to do so. The financial burdens or benefits of WWCR are not a function of whether a corporation is domestic or foreign based but depend upon the business structure and operations of each individual company. Amici, therefore, have a strong interest in this Court restricting its ruling to the legality of compulsory WWCR, and not declaring illegal elective WWCR.

If this Court overrules *Container*, Amici urge that such a decision be rendered on a purely prospective basis. To do otherwise could unfairly expose Amici to potential retroactive tax increases as well as cause severe economic harm to the State of California. It would also give an unfair competitive

advantage to corporations which ignored *Container* over otherwise similarly situated corporations which relied on *Container*.

SUMMARY OF ARGUMENT

Container held that compulsory WWCR for domestic-based corporations is constitutional. This case presents the identical legal issue. Nothing has transpired in the decade since *Container* was decided to warrant overruling it. California has modified its taxing scheme. It no longer requires WWCR which renders the legal issue in this case moot.

Even if this Court were to hold in *Barclays Bank PLC v. Franchise Tax Board*, (No. 92-212 (U.S. Supreme Ct. Oct. 5, 1992) ("*Barclays*") that California's former statutory scheme imposing compulsory WWCR on foreign-based corporations was unconstitutional, that would not justify overruling *Container*. Different treatment of domestic-based corporations is constitutional because of significant differences between foreign and domestic-based corporations, the failure of the federal government to issue a clear directive prohibiting compulsory WWCR for domestic-based corporations, and the greater latitude given to states to tax such corporations.

The financial impact of WWCR on corporations depends upon the structure of their business operations, not their geographical domicile. Accordingly, many domestic-based corporations continue to file on a WWCR basis. Thus, WWCR does not prefer one form of protected commerce over another. Moreover, even if a particular corporation is adversely affected by WWCR, no legal authority supports the proposition that such individual "competitive imbalance" violates either the Foreign Commerce or Equal Protection Clause.

If this Court were to overrule *Container* that decision should be purely prospective. All criteria for prospective application are satisfied since the Court would be overruling a recent decision upon which taxpayers and taxing agencies relied in good faith and retroactive application would produce unfair and inequitable results.

ARGUMENT

A. The Sole Issue In This Case Is The Constitutionality Of Compulsory Worldwide Combined Reporting For Domestic Corporations.

The issue in this case is the constitutionality of compulsory WWCR. The validity of California's current law to allow taxpayers to elect WWCR or water's edge reporting is not

before the Court in this case. CAL. REV. & Tax. Code § 25110. Nor, as some amici seem to suggest in this case and in *Barclays*, is the constitutionality of the basic unitary system at issue. That system has been repeatedly upheld. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *Container*, 463 U.S. at 165. This Court recently reaffirmed that

> we permit States to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State. That is the unitary business principle.

Allied-Signal, Inc. v. Director, Taxation Division, 504 U.S. ____, 119 L.Ed.2d 533, 546 (1992) ("*Allied-Signal*").

Amici currently voluntarily file their California tax returns on a WWCR basis because it is financially advantageous to do so. If this Court were to declare elective WWCR unconstitutional and make its ruling retroactive, Amici will be exposed to unexpected and substantial tax increases for all open tax years. For the above reasons, Amici urge that the ruling in this case be limited to the constitutionality of compulsory

WWCR and that it not address the legality of the current California statutory scheme.

In any event, California's current elective system is perfectly proper. Consistent with the Constitution the states have wide latitude in assessing state income taxes. States are not restricted to a "single formula" for determining state tax liability. *Container*, 463 U.S. at 167, 169.

> To be sure, our cases give States wide latitude to fashion formulae designed to approximate the instate portion of value produced by a corporation's truly multistate activity.

Allied-Signal, 119 L.Ed.2d at 550. Thus, even if compulsory worldwide reporting were held to violate the Constitution for foreign and/or domestic-based taxpayers, states are not prohibited from enacting other formulae including California's current elective worldwide or water's edge reporting system.

B. <u>If This Court Rules In *Barclays* That Compulsory WWCR For Foreign-Based Companies Violates The Constitution, It Does Not Have To Invalidate WWCR For Domestic-Based Taxpayers Or Even Rule At All In This Case</u>.

1. California Has Changed Its Law To Eliminate Compulsory WWCR Rendering The Legal Issue Moot.

The statutory scheme complained of by petitioner has changed substantially since the tax years in question. Compulsory WWCR no longer exists in California. California has modified its tax system to permit foreign-based and domestic-based companies to elect to compute their California tax liability based on a "water's edge" method which generally limits the unitary formula to affiliated entities incorporated within the United States and its possessions. CAL. REV. and Tax. Code § 25110. Corporations electing the water's edge basis originally were required to pay an "election fee" and to file a "domestic disclosure spreadsheet" providing the Franchise Tax Board with information concerning the taxpayer's multistate tax computations. (CAL. REV. and Tax. Code §§ 25114-15.) California amended its tax system in 1993 to eliminate the

election fee and domestic spreadsheet requirements. (STATS. 1993, ch. 881.) Thus, petitioner is urging this Court to overrule *Container* so as to declare unconstitutional a statutory scheme that no longer exists.

2. The Same Foreign Commerce Clause Issues Raised By Petitioner Were Decided In *Container*; Nothing Has Changed In The Intervening Short Time Period To Warrant Overruling *Container*.

Petitioner claims that compulsory WWCR as applied to domestic-based corporate groups violates the Foreign Commerce Clause because it prevents the federal government from "speaking with one voice." This exact argument was rejected in *Container*.

> . . . the foreign policy of the United States -- whose nuances, we must emphasize again, are much more the province of the Executive Branch and Congress than of this Court -- is not seriously threatened

> by California's decision to apply the unitary business concept and formula apportionment in calculating appellant's taxable income.

Container, 463 U.S. at 196.

Nothing has occurred since *Container* was decided that warrants its modification. Unlike the situation in *Barclays*, neither the Executive Branch nor any foreign government has involved itself in *Colgate* on petitioner's behalf. No congressional action suggests that Congress intends that California be barred from applying compulsory WWCR to domestic-based companies.

Petitioner's argument rests on the flimsiest "evidence." It cites only the "missing evidence of the Executive Branch's opposition to worldwide combined reporting" (Pet. Br. at p. 34) and claims as "a clear federal directive," private letters between petitioner's chairman and a former Cabinet official, and other private correspondence. This does not demonstrate clear federal policy against WWCR as is required under the dormant Foreign Commerce Clause analysis to invalidate a state tax. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979)

("*Japan Line*"). Thus, it does not constitute justification for overruling *Container*.

3. Except In Extraordinary Circumstances, This Court Should Not Overrule A Prior Decision.

The doctrine of *stare decisis* and other jurisprudential considerations require exceptional circumstances to overrule prior decisions, particularly a recent one like *Container*. No such circumstances have been cited by petitioner. Rather, the lack of federal governmental action affecting the dormant Foreign Commerce Clause analysis, and significant alteration of the challenged statutory scheme rendering the legal issue moot, mandate affirmance or dismissal.

Recent decisions affirm that the doctrine of *stare decisis* is strictly followed in taxpayer cases, particularly those involving justifiable reliance by the states or taxpayers. Such reliance was a crucial factor in this Court's refusal to "abandon our settled jurisprudence defining the limits of state power to tax under the unitary business principle." *Allied-Signal*, 119 L.Ed.2d at 551. Similarly, this Court, recognizing the settled expectations of taxpayers and taxing agencies, declined an invitation to overrule an earlier decision governing state sales and use taxes on

interstate commerce. *Quill Corp. v. North Dakota*, 504 U.S. ____, 119 L.Ed.2d 91 (1992) ("*Quill Corp.*"). The Court noted:

> The 'interest in stability and orderly development of the law' that undergirds the doctrine of *stare decisis* therefore counsels adherence to settled precedent.

Id., at 110 (citations omitted); see *Runyon v. McCrary*, 427 U.S. 160, 190-191 (1976) (Stevens, J., concurring).

Just last term this Court relied on *Container* in deciding *Itel Containers International. Corp. v. Huddleston*, 507 U.S. ____, 122 L.Ed.2d 421 (1993) ("*Itel*"). In *Itel*, this Court upheld a Tennessee sales tax on leases of cargo containers used in foreign commerce. In discussing whether that taxation scheme more resembled that in *Japan Line*, or in *Container*, this Court gave no indication that the continued viability of *Container* was in question. *Itel*, 122 L.Ed.2d 421, 434-437. To abruptly abandon *Container*, particularly in light of this record, would defeat the policies of protection of reliance interests and stability and orderly development of the law underlying the doctrine of *stare decisis*.

4. The Decisions In *Barclays* And *Colgate* Need Not Be The Same.

The factual, legal and policy implications in *Barclays* differ substantially from those in the instant case. As noted above, neither the federal nor a single foreign government has asserted itself in this case, a marked contrast with *Barclays*.

The federal government is a party to a number of tax treaties which require the use of the arm's length/separate accounting method in allocating the United States income of foreign-based multinational enterprises. However, that requirement is "generally waived with respect to the taxes imposed by each of the contracting nations on its own domestic corporations." *Container*, 463 U.S. at 196. As an example, the federal government's income tax treaty with the United Kingdom, a nation active in the campaign to proscribe the application of compulsory WWCR to foreign-based companies, states:

> (3) Notwithstanding any provision of this Convention . . . a Contracting State may tax its residents . . . and its nationals as if this Convention had not come into effect.

Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, Dec. 31, 1975, Article 1, Section (3). (Jt. Stip., Exhibit 46gg.)

In addition, there are significant differences between foreign and domestic-controlled corporate groups as regards state taxation. As recognized by the federal government, domestic-based groups have primary and substantial contacts with the states and are organized and conditioned to respond to reporting requirements, while foreign-based groups with minimal contacts in the United States may encounter burdensome reporting requirements. Jt. Stip. Exhibit 43d at pp. 7-9.

These significant differences were conceded by amici for the petitioners in *Barclays*:

> Difference of both principle and practicality explain why the foreign reaction is so much stronger when California applies its tax to a foreign-based company. First, it is a fundamental precept of international law, and an underlying theme of *Container*, that a nation

> may tax its own domiciliaries as it chooses. The balance of interests shifts when one nation seeks to tax the domiciliary of another in a manner at odds with international norms. Second, the record here demonstrates that the compliance burdens for foreign companies far exceed those for domestic companies, thereby adding a discriminatory gloss to an already aberrant system.

Brief of Amici Curiae National Foreign Trade Council, Inc. et al. in Support of Petition for Certiorari - *Barclays Bank PLC v. Franchise Tax Board* at p. 3.

Ironically, these same amici make the opposite argument in the instant case. Brief of Amici Curiae Chamber of Commerce of the United States, et al. in Support of Petitioner Colgate Palmolive at p. 17; Brief of Amici Curiae National Foreign Trade Council, et al. in Support of Petitioner Colgate Palmolive at pp. 28-29.

Neither legal nor policy considerations require this Court to adopt the same rule in *Colgate* as in *Barclays*.

5. There Is No Support In The Constitution For Petitioner's "Competitive Balance" Argument.

Petitioner argues that if this Court decides in favor of Barclays, it must also rule for Colgate because the Foreign Commerce Clause compels "competitive balance" for domestic corporations as an integral part of federal foreign policy.

Petitioner offers no authority that "competitive balance" is an element in Foreign Commerce Clause analysis. None exists.

Nor does petitioner's "competitive balance" argument find any support in equal protection jurisprudence. No case holds that the Equal Protection Clause is violated by compulsory WWCR for domestic-based taxpayers.

The Constitution does not forbid laws which differentiate between classes of persons, but merely prevents governmental decision makers from "treating differently persons who are in all relevant respects alike." *Nordlinger v. Hahn*, 505 U.S. ____, 120 L.Ed.2d 1, 12 (1992) ("*Nordlinger*") (citing *F.S. Royster Guano Co. v. Virginia*, 253 U.S. 412, 415 (1920)). Unless a classification implicates the exercise of a fundamental right or involves an inherently suspect classification, the Equal Protection Clause

requires only that it rationally further a legitimate state interest. *Cleburne v. Cleburne Living Center, Inc.*, 473 U.S. 432, 439-441 (1985); *New Orleans v. Dukes*, 427 U.S. 297, 303 (1976). States have especially broad latitude in creating classifications and distinctions in tax statutes. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973) ("*Lehnhausen*"); *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 547 (1983).

Petitioner's argument erroneously implies that WWCR is disadvantageous to all taxpayers and that it is possible to predict the financial impact of WWCR depending upon where a taxpayer is domiciled. Thus, it erroneously argues that allowing foreign-based corporations to file on a water's edge basis while requiring WWCR for domestic corporations discriminates against the latter by necessarily making them less competitive. (Pet. Br. p. 42-45.)

However, whether a taxpayer is advantaged or disadvantaged by WWCR is a function of a number of factors unrelated to whether it is foreign or domestic based. For example, a domestic-based company that has foreign operations which generate tax losses which offset domestic taxable income will have lower California taxes under WWCR than under water's edge reporting. Amici, domestic-based corporations engaged in worldwide commerce, continue to file voluntarily on a WWCR basis because it is beneficial to do so given the

specifics of their business operations. Similarly, under California's current elective system, some foreign-based corporations continue to file voluntarily on a WWCR basis, presumably because it is advantageous to do so.

Thus, there is no necessary correlation between one's status as a foreign or domestic-based corporation and any tax advantage or disadvantage due to WWCR. Rather, any higher California taxes are a result of the structure of a corporation's individual business operations. The Commerce Clause is not violated when the differential tax treatment of two categories of companies relates solely to differences in the nature of their businesses and does not stem from the location of their activities. *Amerada Hess Corporation v. New Jersey Department of the Treasury*, 490 U.S. 66, 78 (1989).

While petitioner apparently will benefit by filing a water's edge return, that does not violate equal protection guarantees. There is no "burdened class" in which all members are harmed by the taxing statute and, as noted herein, a rational basis exists for treating differently foreign and domestic-based corporations. *Nordlinger*, 112 L.Ed.2d 1 [ad valorem taxation based on date of acquisition of property]; *Lehnhausen*, 410 U.S. 356 [ad valorem tax on personal property of corporations and other non-individuals only]; *Allied Stores of Ohio v. Bowers*, 358 U.S. 522

(1959) [ad valorem tax on merchandise and agricultural products stored in warehouses by non-residents]).

6. A Different Rule Concerning WWCR For Domestic And Foreign-Based Companies Does Not Unconstitutionally Favor One Form Of Protected Commerce Over Another.

Petitioner erroneously asserts that a decision in favor of *Barclays* and against *Colgate* would favor the foreign commerce of a foreign corporation over that of a domestic corporation in violation of the Foreign Commerce Clause. (Pet. Br., pp. 45-47.) First, as noted above, neither foreign nor domestic-based corporations would be preferred because there is no correlation between domicile and any benefit or burden of WWCR.

Second, petitioner's reliance on *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977) ("*Boston Stock Exchange*"), is misplaced. That case did not involve the Foreign Commerce Clause. It held that a New York statute whose express purpose was to promote New York stock exchanges and that facially discriminated against nonresidents and out-of-state stock exchanges violated the Interstate Commerce Clause.

Petitioner's strained reading of *Boston Stock Exchange* to mean that no state statute can ever favor one form of protected commerce over another cannot be sustained in light of the later rulings in *Japan Line* and *Container*. Both opinions recognize that state taxation schemes constitutionally can favor one form of commerce over another. *Japan Line* held unconstitutional a California property tax on foreign-owned and based cargo containers used in foreign commerce. Yet, *Japan Line* expressly stated that the California property tax was constitutional as applied to interstate commerce, another form of "protected commerce." *Japan Line*, 441 U.S. at 445. Moreover, *Japan Line* did not invalidate the California property tax as it applied to cargo containers used in foreign commerce by domestic corporations. That result negates petitioner's *Boston Stock Exchange* argument.

In upholding WWCR for domestic corporations in *Container* this Court also recognized that under the dormant Foreign Commerce Clause there are distinctions between foreign and domestic corporations engaged in foreign commerce that affect the constitutionality of state taxation laws. *Container*, 463 U.S. at 194-97. Thus, petitioner's *Boston Stock Exchange* argument really is that *Container* and *Japan Line* were wrongly decided.

Finally, the summary affirmance without opinion of *Zee Toys, Inc. v. County of Los Angeles*, 85 Cal. App.3d 763, 149 Cal Rptr. 750 (2d Dist. 1978) *aff'd sub nom. Sears, Roebuck & Co. v. County of Los Angeles*, 449 U.S. 1119 (1981) also cannot support petitioner's expansive reading of *Boston Stock Exchange* (Pet. Br. at p. 47). This Court's action in *Zee Toys* predated *Container*, yet neither *Zee Toys* nor *Boston Stock Exchange* were cited by the majority nor the dissent in *Container* for the proposition suggested by petitioner.

Adopting petitioner's view of *Boston Stock Exchange* would require this Court to reject its prior analysis in *Japan Line* and *Container* and is not supportable on legal or policy grounds.

C. If This Court Overrules *Container*, The Decision Should Be Purely Prospective.

1. This Case Satisfies The Criteria For Purely Prospective Application.

This Court has often rendered its decisions on a "purely prospective" basis. *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) ("*Chevron Oil*"); *Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, 458 U.S. 50, 88 (1982); *Buckley v. Valeo*,

424 U.S. 1, 142-143 (1976): *England v. Louisiana State Board of Medical Examiners*, 375 U.S. 411, 422 (1964).

> [T]he propriety of prospective application of decisions in this Court, in both constitutional and statutory cases, is settled by our prior decisions.

James B. Beam Distilling Company v. Georgia, 501 U.S. _____, 115 L.Ed.2d 481 (1991) (White, J., concurring) ("*James Beam*"). Further,

> the paradigm case [for nonretroactivity] aris[es] when a court expressly overrules a precedent upon which the contest would otherwise be decided differently and by which the parties may previously have regulated their conduct.

James Beam, 115 L.Ed.2d at 487.

While this Court recently disapproved "selective prospectivity," holding that a decision "applied to the parties of

the controversy, must be given full retroactive effect . . . ," it acknowledged the continued viability of the doctrine of pure prospectivity. *Harper v. Virginia Department of Taxation*, 509 U.S. _____ , 125 L.Ed.2d 74, 86 (1993) ("*Harper*"); *James Beam*, 115 L.Ed.2d 481. Justice Thomas noted that the Court may "reserve the question whether its holding should be applied to the parties before it" thereby affirming the option of applying the decision only in the future. *Harper*, 125 L.Ed.2d at 86-87 (quoting *James Beam*).

Moreover, the traditional test set forth in *Chevron Oil* for determining whether a decision should be applied retroactively, which obviously no longer applies to the now abandoned doctrine of selective retroactivity, still governs as to when an opinion may be applied purely prospectively. *Harper*, 125 L.Ed.2d at 87, 95-96 (Kennedy, J., concurring); *James Beam*, 115 L.Ed.2d at 493.

The first requirement of the *Chevron Oil* test is that

> the decision to be applied nonretroactively must establish a new principle of law, either *by overruling clear past precedent* on which litigants may have relied,or by deciding an issue of first impression whose resolution was not clearly foreshadowed.

Chevron Oil, 404 U.S. at 106 (citations omitted; emphasis added). Clearly, that criteria would be satisfied if *Container*, decided a mere 10 years ago, were unexpectedly overruled.

Second, the case must be evaluated "looking to the prior history of the rule in question, its purpose and effect, and whether retroactive operation will further or retard its operation." *Id.*, at 107. This aspect of the test is also satisfied. Here the statutory scheme has already been amended twice to eliminate compulsory WWCR. The legal issue is moot. If *Container* is overruled, certain taxpayers such as petitioner who have filed claims may receive income tax refunds, and other taxpayers such as Amici whose tax returns remain "open" for certain years for reasons having nothing to do with WWCR, may be assessed additional taxes. However, no public policy supporting a court ruling prohibiting compulsory WWCR will be harmed by having the decision apply on a purely prospective basis.

The third prong of the *Chevron Oil* test is particularly critical and relevant in this case. The Court must weigh any inequities caused by retroactive application. *Id.*, at 107. Thus, the public policy and jurisprudential factor of good faith

reliance that also underlies the doctrine of *stare decisis* compels that any decision overruling *Container* be applied on a purely prospective basis. In refusing to overturn prior case law governing unitary tax principles, this Court noted that

> State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State. . . . And, of course, we would defeat the reliance interest of those corporations which have structured their activities and paid their taxes based upon the well-established rules we here confirm.

Allied-Signal, 119 L.Ed.2d at 551 (citations omitted).

Like the situation in *Allied-Signal* and the "*Bellas Hess* rule" that was not overturned in *Quill Corp.*, *Container* "has engendered substantial reliance. . . ." Moreover, that reliance is clearly justified.

> [R]eliance upon a square, unabandoned holding of the

> Supreme Court is *always* justifiable reliance (though reliance alone may not always carry the day).

Quill Corp., 119 L.Ed.2d at 112 (Scalia, J., concurring).

Relying upon *Container*, California collected, and most corporations paid without challenge, taxes in accordance with compulsory WWCR for the years it was in effect. However, if a decision overruling *Container* were applied retroactively, the state could be required to pay refunds in the approximate amount of $1.2 billion to those domestic corporations that filed claims for refund challenging compulsory WWCR (Pet. Br. at 38). Similarly, Amici and others similarly situated who have filed tax returns in accordance with WWCR but have "open tax years" possibly could be assessed substantial additional taxes in excess of several hundred million dollars if their tax returns were invalidated and taxes assessed on a different method.

Retroactive application would cause severe economic hardship to the state. Significant financial hardship on governmental bodies has been held to be a basis for not applying a decision retroactively. *Cipriano v. Houma*, 395 U.S. 701, 706 (1969). "[W]e ought not to visit economic hardship upon those who took us at our word." *Quill Corp.*, 119 L.Ed.2d at 112 (Scalia, J., concurring).

The objective of placing similarly situated taxpayers on "a level playing field" by eliminating the effects of past discrimination also would not be furthered by retroactivity. See *McKesson v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 48-50 (1990) ("*McKesson*"). The situation here contrasts markedly with those in which out-of-state companies had greater tax burdens imposed on them by statutes facially discriminating in favor of in-state companies. Where, for example, tax preferences were provided for local distributors of liquor, *McKesson*, and for locally registered commercial vehicles, *American Trucking Assns., Inc. v. Scheiner*, 483 U.S. 266 (1987) retroactive application forced the state to tax both in and out-of-state companies on the same basis to rectify financial hardship caused by unequal treatment. That is not a consideration in this case where the statute prescribed the same method of taxation for both foreign and domestic-based corporations.

Further, acting in reliance on *Container*, many taxpayers who would have preferred to file on a water's edge basis, did not file claims with the Franchise Tax Board, a prerequisite under California law to receiving a refund. CAL. REV. & Tax. Code §§ 25664, 25665, 26102. Retroactive application of a decision overruling *Container* will give those taxpayers who did file claims a competitive windfall by allowing them to receive refunds. At the same time it would penalize identically situated

taxpayers who respected *Container* and did not file refund claims.

2. Retroactive Application Would Harm California's System Governing Administrative Appeals By Taxpayers.

California requires all issues to be raised in a taxpayer's administrative claim for refund or be waived if a suit for refund is commenced. CAL. REV. & Tax. Code § 26102; *Title Insurance Co. of Minnesota v. State Board of Equalization*, 4 Cal.4th 715 (1992). If this Court overrules a recently decided case like *Container*, particularly on this record, it will adversely affect the administrative tax refund claims and appeals process in California. Taxpayers and practitioners will be under severe pressure to contest every imaginable issue, even when there is an opinion of this Court squarely on point. If they fail to do so, and this Court unexpectedly overrules a recent decision and applies the new rule retroactively, they may be exposed to charges of negligence from shareholders or clients. Challenges raising every conceivable issue whether well-settled or not, could bring the state tax appeals system to a standstill.

CONCLUSION

The decision of the California Court of Appeal should be affirmed.

Respectfully submitted,

ERIC J. MIETHKE*
JOHN E. MUELLER
NIELSEN, MERKSAMER,
PARRINELLO, MUELLER
& NAYLOR

DEANE E. MCCORMICK, JR.
SHERIDAN M. CRANMER
LITTON INDUSTRIES, INC.

DEBRA A. GASTLER
THE TIMES MIRROR COMPANY

Counsel for Amici Curiae

*Counsel of Record
January 18, 1993.

No. 92-1538

In the Supreme Court of the United States

OCTOBER TERM, 1993

COLGATE-PALMOLIVE COMPANY
Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

AMICUS CURIAE BRIEF ON BEHALF OF THE STATES OF ALASKA, MONTANA, NEW HAMPSHIRE, AND OREGON, IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

STEPHAN H. WILLIAMS
Attorney at Law
[illegible] Suite 400
[illegible], Alaska 99501
[illegible]
Of Counsel for
the State of Alaska

BRUCE M. BOTELHO
Attorney General of
the State of Alaska

LAURI I. ADAMS
Counsel of Record
Assistant Attorney General
1031 West 4th Avenue
Suite 200
Anchorage, Alaska 99501
(907) 269-5100

Attorneys for Amici Curiae

January 18, 1994

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In the Supreme Court of the United States

OCTOBER TERM, 1993

No. 92-1839

COLGATE-PALMOLIVE COMPANY
Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the
State of California in and for the Third Appellate District

AMICUS CURIAE BRIEF ON BEHALF OF THE
STATES OF ALASKA, MONTANA,
NEW HAMPSHIRE, AND OREGON, IN SUPPORT OF
RESPONDENT FRANCHISE TAX BOARD

INTERESTS OF *AMICI CURIAE*

The States that have joined in this *amicus curiae* brief in support of the respondent State of California Franchise Tax Board[1] all have utilized the unitary business principle and formula apportionment to tax the net incomes of multistate and multinational corporations which conduct business in each State. None of the *amici* utilizes the Arms Length/Separate Accounting method for such businesses.

---

[1] This *amicus curiae* brief is submitted by the Attorneys General of the States of Alaska, Montana, New Hampshire, and Oregon in support of the respondent State of California Franchise Tax Board. The same *amici* have submitted a separate brief in the companion case of *Barclays Bank PLC v. Franchise Tax Board*, Docket No. 92-1384, which was consolidated with this case by Order of the Court. 62 U.S.L.W. 3319 (U.S. Nov. 2, 1993).

The State of Alaska applies worldwide combined reporting as the required method of income reporting for certain classes of corporate taxpayers,[2] and other of the *amici* States have utilized the worldwide unitary system in prior tax years, or do so pursuant to taxpayer election.[3]

Even States that have in recent years modified their worldwide unitary apportionment formulas nevertheless have significant tax revenues at risk because that formula was applied in prior years for which there are still open tax proceedings. In some cases, these open tax cases date back many years.[4] As a result, cumulatively, billions of dollars are at stake for all the States.[5] Even if it is assumed that the *amici* could make changes in their tax statutes to cure any constitutional defects found by this Court, the matter of their already assessed prior years' taxes might not be resolved by such changes. Thus, the refund claims which are sure to result

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[2] Alaska Stat. § 43.20.072 (1990 & Supp. 1993) applies a version of the worldwide unitary method of apportionment to taxpayers engaged in the production of oil and gas from leases or property within the State of Alaska, as well as to taxpayers engaged in the transportation of oil or gas by pipeline within the State.

[3] Montana utilizes the worldwide combined reporting method, but also has a water's edge election available to taxpayers. Mont. Stat. § 15-31-301 *et seq.* New Hampshire and Oregon both assessed taxes on unitary businesses on a worldwide combined reporting basis prior to 1986. In subsequent years each State has applied a specific "water's edge" formulation. *See* N.H. Rev. Stat. § RSA 77-A, *amended by* RSA 77-A:2-b (Ch. 153:4, New Hampshire Laws of 1986). *See also* Or. Rev. Stat. § 314.363, *amended by* ORS § 317.715 (eff. January 1, 1986).

[4] In the case of Alaska, for example, there are currently pending state tax proceedings under the worldwide unitary method which include up to twelve years of prior tax assessments, dating back to 1982.

[5] All the *amici* have open taxpayer proceedings which involve prior years' assessments under the worldwide unitary method. The dollars at risk in the different States range from a low of approximately three and one-half million dollars to a high of well in excess of five hundred million. California, of course, has already indicated that it stands to lose over four billion dollars in tax revenues if its worldwide unitary tax scheme is invalidated as to both Barclays and Colgate-Palmolive. *Barclays* Supp. Brief, at 1; Resp. Brief in Opp. to Cert. in *Colgate-Palmolive*, at 15.

from a reversal of the California court's decision could disrupt States' finances significantly.

In addition to their direct fiscal interests, the *amici* States all have broader interests in retaining the authority and the flexibility, which has not been circumscribed by Congress, to adopt reasonable unitary apportionment methods and to make changes in their statutory tax structures over time as needed to address their fiscal and administrative needs.[6] Indeed, it was largely because of the administrative difficulties and costs inherent in applying the separate accounting tax method to modern multistate and multinational corporations that almost all States have turned from it to the unitary method for taxing such businesses since World War II.[7] If the Court accepts the petitioner's arguments that national uniformity interests in the separate accounting method now rise to the level of a constitutional requirement, the *amici* States' ability to continue to apply reasonable, cost-effective unitary tax schemes to meet changing business realities would be stymied. The *amici* States joining in this brief have a strong interest in avoiding such a costly and inefficient result.

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[6] *See* 1 J. Hellerstein & W. Hellerstein, State Taxation, ¶ 8.03 at 8-29 (2d ed. 1993) (*hereinafter cited* as Hellerstein Treatise). Individual States have adopted variations and refinements in the formula apportionment model, and, as a result, even though the general rule of the unitary business principle is adhered to by nearly all States, no two State tax laws are completely identical. *Id.*, ¶ 9.06 at 9-23, & n. 72.

[7] The Hellerstein Treatise reports that forty-five of the forty-six States (including the District of Columbia) that levy corporate income taxes have adopted some version of the unitary method and formula apportionment to apply to multistate and multinational businesses. Hellerstein Treatise, ¶ 9.02, Table 9.1 at 9-8; ¶ 9.06 at 9-23. *Amici* have discussed the clear advantages of the unitary method over separate accounting in taxing multistate and multinational corporations in the separate brief they have filed in regard to the *Barclays* petition. *See* note 1, *supra*.

SUMMARY OF ARGUMENT

In their separate brief submitted in the companion *Barclays* petition, *amici* have presented compelling reasons why California's worldwide unitary tax method should be upheld as constitutional under the Foreign Commerce Clause. Colgate raises many of the same arguments as Barclays, but it is on even weaker ground because it is a domestic-domiciled corporation, and thus falls squarely within the holding of *Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983)*, which upheld worldwide unitary taxation as applied to domestic corporations with foreign subsidiaries.

Implicitly recognizing the insurmountable difficulty it faces in overcoming the clear holding in *Container*, Colgate-Palmolive bootstraps itself on the legal arguments presented by Barclays. For without Barclays, Colgate-Palmolive's arguments are foreclosed by *Container*, which was decided on indistinguishable facts.

Thus, if the California Supreme Court's opinion in *Barclays Bank PLC v. Franchise Tax Board*, 829 P.2d 279 (Cal. 1992), is affirmed by this Court, the California appeals court's opinion in *Colgate-Palmolive Co. v. Franchise Tax Board*, 10 Cal. App. 4th 1768, 13 Cal. Rptr. 2d 761 (3d Dist. 1992), also should be affirmed. It is only if the California courts' opinions are reversed that the question of what taxpayer relief is appropriate will need to be addressed. The relief issue is the narrow issue *amici* will address in this brief.

As noted above, the *amici* all have ongoing taxpayer proceedings in their own States involving large sums of tax revenues, which could be jeopardized by a reversal of the California court's decision in *Colgate-Palmolive*. Because the *amici* justifiably relied on this Court's holding in *Container* that the same worldwide apportionment method challenged here was constitutional, the Court's retroactive application of any different constitutional rule announced in this case to other cases still open on review would be particularly unjust and burdensome on the States. Purely prospective application of any "new principle of law" established here is thus both appropriate and necessary.

Finally, even if the Court applies its decision in *Colgate-Palmolive* retroactively, this Court's precedents establish that a remand of the case to the California courts is the proper course to determine what taxpayer relief is necessary consistent with the newly announced constitutional requirements.

ARGUMENT

I. IF *COLGATE-PALMOLIVE* IS REVERSED, THE RULING SHOULD BE APPLIED PROSPECTIVELY ONLY, AND IN ANY EVENT, THE ISSUE OF THE PROPER REMEDY SHOULD BE REMANDED TO THE CALIFORNIA COURTS.

The *amici* States believe that a proper analysis of the issues in both the *Barclays* and *Colgate-Palmolive* petitions, as presented by the respondent California Franchise Tax Board, will result in this Court affirming the California courts' decisions below. In that event, the Court will have no need to reach the separate issue of what relief to provide the taxpayers. However, the fiscal impact on the *amici* States of a reversal in *Colgate-Palmolive* would be so severe and unexpected in light of the clear holding of the *Container* opinion, that the *amici* believe any such decision should be applied prospectively only.

If ever a situation called for purely prospective relief, it is the *Colgate-Palmolive* petition. To adopt petitioner's arguments, this Court would unavoidably have to overrule *Container*. This case thus presents a classic situation for application of the three-part balancing test for prospective application of a newly announced principle of law which was established in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971).[8]

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[8] The *Chevron* factors for determining whether a new constitutional rule announced by the Court should only be given prospective application are: (1) the decision must "establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, ... or by deciding an issue of first

(continued...)

If the California court is reversed, it is imperative that the Court address and explicitly decide the prospectivity issue. In *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990), and *American Trucking Assoc., Inc. v. Smith*, 496 U.S. 167 (1990), the Court limited its prior rule on when prospective relief is appropriate following announcement of a new constitutional principle. The Court's subsequent decisions in *James B. Beam Distilling Co. v. Georgia*, 111 S.Ct. 2439, 2446 (1991), and *Harper v. Virginia Dept. of Taxation*, 113 S.Ct. 2510, 2517 (1993), eliminated the doctrine of "selective prospectivity," under which a new rule announced by the Court is applied to the litigants before the Court and to all situations arising after the Court's ruling, but the old rule continues to apply to all others whose causes of action arose from facts predating the Court's ruling. *See also* Hellerstein Treatise, ¶ 4.12[4][c] at 4-94.

James Beam and *Harper* also declared that where the Court does not reserve the prospectivity issue, or give its new constitutional rule purely prospective application, "once announced and applied to the parties to the controversy," ... "that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule." *Harper*, 113 S.Ct. at 2517; *James Beam*, 111 S.Ct. at 2447. The effect of these recent decisions is to limit the application of the *Chevron* balancing criteria to the issue whether the newly announced constitutional rule should be applied only to events occurring after the date of the decision and, consequently, not to the litigants then before the Court. *See American Trucking*, 496 U.S. at 199-200.

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[8](...continued)
impression whose resolution was not clearly foreshadowed;" (2) the court must "weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation;" and (3) the court must determine whether the new rule, if imposed retroactively, "could produce substantial inequitable results;" if it would, the court may apply the rule prospectively in order to avoid "injustice or hardship." *Chevron*, 404 U.S. at 106-07.

This change in the Court's rule concerning prospective relief poses a serious dilemma for *amici*. They are not parties to the *Colgate-Palmolive* petition; yet if the Court reverses the California court and applies its ruling to the *Colgate-Palmolive* petitioners, under *Harper* and *James Beam*, the decision will also automatically apply to all ongoing taxpayer actions in all States that have ever utilized the worldwide unitary method. This is so even if the Court does not address the prospectivity/retroactivity question at all in its opinion in these petitions.

This possibility is obviously a major concern for States that have relied upon the constitutionality of the worldwide unitary method, expressly upheld in the *Container* decision, and which for years have taxed multinational corporations using that apportionment method. *See, e.g., Allied-Signal, Inc. v. Director, Division of Taxation*, 112 S.Ct. 2251, 2262 (1992) ("State legislatures have relied upon our precedents by enacting tax codes"). If a different constitutional interpretation is now adopted, it will certainly "disrupt settled expectations in an area of the law in which the demands of the national economy require stability." *Allied-Signal*, 112 S.Ct. at 2262. *See also Quill Corp. v. North Dakota*, 112 S.Ct. 1904, 1916 (1992), and the concurring opinion of Justice Scalia, at 1923-24 ("we ought not to visit economic hardship upon those who took us at our word"). Thus, if the Court does reverse the California court in *Colgate-Palmolive*, there are compelling, equitable reasons for the Court to apply the newly announced rule prospectively only.

All three of the *Chevron* prospectivity criteria are easily satisfied in *Colgate-Palmolive*. *See, supra*, note 8. First, the decision would establish a new rule of law undoing more than seventy years of Supreme Court decisions approving the unitary tax method as applied to both foreign and domestic-parent corporations; such a decision would also, of necessity, overrule this Court's express holding in *Container*, upon which States have relied for more than a decade. Second, giving prospective application to such a new constitutional rule in this petition would serve a valid purpose because Colgate-Palmolive still would be relieved of significant tax liability in future years. Third, retroactive application to other tax cases would result in severe "injustice and hardship," not only to

California, but also to all States that have applied the unitary method and have taxpayer proceedings presently pending involving prior years' tax assessments.

As discussed *supra*, retroactive application of a new ruling in *Colgate-Palmolive* could jeopardize billions of dollars in tax revenues which States can scarcely afford to lose at a time when they are having difficulty providing basic services to their citizens. The likely practical effect would be to shift a heavier state tax burden onto purely domestic businesses, which are generally smaller, while the large multinational corporations would have their tax burdens eased.[9] And it would be difficult to replace such significant lost revenues through new or increased taxes, given the States' concern with the need for maintaining tax stability to attract and retain new businesses in a competitive international economy. For all these reasons, the *amici* States urge the Court to apply any new constitutional rule announced in *Colgate-Palmolive* prospectively only, or, alternatively, to reserve the issue and remand it to the California courts for consideration in light of the Court's opinion.

Finally, even if this Court reverses the California court and applies its decision retroactively to the petitioner here, the Court should still remand *Colgate-Palmolive* back to the California courts to consider what specific relief should be granted. That approach would be consistent with *McKesson*, where the Court distinguished between the issue of prospective versus retroactive application of its ruling, which it held to be a question of federal law, and the separate determination of the appropriate remedy to be afforded a taxpayer, which is inevitably intertwined with and involves issues of State law. *McKesson*, 496 U.S. at 39-40.

There are various ways a State could reformulate and enforce its tax laws to satisfy constitutional objections under the Commerce

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[9] 124 Cong. Rec. S18666 (June 23, 1978) (Remarks of Prof. Zeifman in Taxing Multinationals--A CTRA Foundation Analysis: "Relatively small-sized businesses which do not have the advantage of operating across state lines are in the same boat. So, in a sense, the ... proposal to at least partially abolish the unitary method is a way of offering gigantic tax subsidies to non-California businesses at the expense of California businesses and individual taxpayers.")

Clause. *Id.* An appropriate remedy might involve the modification, but not the complete invalidation, of an offending State tax law; it would undoubtedly require development of a more extensive factual record than is now before the Court. A refund of all taxes paid under the tax method might be neither the only nor the most efficacious remedy.

Where, as here, the highest state court below has not addressed the issue of relief, this Court has declared its reluctance to address that issue in the first instance and has instead remanded to the state courts for development of an appropriate factual record and an initial decision concerning relief. *See, e.g., James Beam*, 111 S.Ct. at 2448; *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984). The Court has also held that States should be given flexibility to devise their own remedies to meet new Commerce Clause constitutional requirements concerning State taxation. *McKesson*, 496 U.S. at 39-40, & n. 23. *See also Harper*, 113 S.Ct. at 2519-20; *James Beam*, 111 S.Ct. at 2448. In the event of a reversal, therefore, the *amici* States request the Court expressly to remand the case to the California courts to develop an appropriate record, evaluate State and taxpayer concerns, and fashion an appropriate remedy.

CONCLUSION

For the reasons stated in this brief and in the *amici* States' brief in the companion *Barclays* petition, California's corporate tax, as applied to Barclays and Colgate-Palmolive, is clearly constitutional. Therefore, the *amici* States respectfully submit that the decisions of the California courts in both petitions should be affirmed. However, in the event *Colgate-Palmolive* is reversed, that decision should be applied prospectively only, or the issue should be

reserved and remanded, along with any taxpayer relief issues, to the California courts for their determination in the first instance after developing a more complete record than is before the Court here.

Respectfully Submitted,

BRUCE M. BOTELHO
Attorney General of the
State of Alaska
LAURI J. ADAMS
Assistant Attorney General
Counsel of Record
STEPHAN H. WILLIAMS
Attorney at Law
Of Counsel for the State of Alaska

JOSEPH P. MAZUREK
Attorney General of the
State of Montana

JEFFREY R. HOWARD
Attorney General of the
State of New Hampshire

THEODORE R. KULONGOSKI
Attorney General of the
State of Oregon

Attorneys for *Amicī Curiae*

(41) (21)

Nos. 92-1384, 92-1839

Supreme Court, U.S.
FILED
JAN 14 1994
OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writs Of Certiorari To The Court Of Appeal Of The State of California In And For The Third Appellate District

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF OF CALIFORNIA LEGISLATURE AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

BION M. GREGORY*
Legislative Counsel of California
3021 State Capitol
Sacramento, CA 95814
(916) 445-2782

JAMES A. MARSALA
Principal Deputy
Legislative Counsel

BALDEV S. HEIR
MICHAEL R. KELLY
Deputies Legislative Counsel

Attorneys for Amicus Curiae California Legislature

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE

The California Legislature hereby respectfully moves for leave to file the attached brief amicus curiae in these cases. The consents of the attorneys for the respondent have been obtained. The consents of the attorneys for the petitioners were requested but refused.

The interest of the California Legislature in these cases arises from the fact that the California Legislature holds the express power to enact legislation to impose taxes upon corporations in the State of California pursuant to the California Constitution. Any limitation on the use of worldwide combined reporting to determine taxable income attributable to California would have the effect of circumscribing that power of the California Legislature. The brief of amicus curiae will set forth arguments relating to (1) the impact that the issues raised before the Court have upon the sovereign taxing power of California and (2) the efforts of the California Legislature to exercise the State's power to tax, with respect to corporations that are doing business in California and are engaged in a unitary business with foreign affiliated corporations, with due regard to California's budgetary constraints, with fairness to all affected taxpayers, and in deference to federal governmental concerns regarding the state's use of worldwide combined reporting.

The California Legislature believes that it can provide a different perspective to the Court in its examination of the issues presented, and that its arguments, if

accepted, would be dispositive of many of the issues presented in these cases.

Respectfully submitted,

BION M. GREGORY
Legislative Counsel of California
3021 State Capitol
Sacramento, CA 95814
(916) 445-2782

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BARCLAYS BANK PLC v. FRANCHISE TAX BOARD
COLGATE-PALMOLIVE COMPANY v.
FRANCHISE TAX BOARD

BRIEF OF CALIFORNIA LEGISLATURE AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

The California Legislature submits this brief, as amicus curiae, pursuant to Rule 37 of the Rules of the Supreme Court of the United States, in support of respondent.

INTEREST OF AMICUS CURIAE

The California Legislature holds the express power to impose taxes upon corporations in the State of California pursuant to the California Constitution. Any limitation on the use of worldwide combined reporting to determine taxable income attributable to California would have the effect of circumscribing that power of the California Legislature. This brief will demonstrate (1) the impact that the issues raised before the court have upon the sovereign taxing power of the California Legislature and (2) the efforts of the California Legislature to exercise this power, with respect to corporations that are doing business in California and are engaged in a unitary business with foreign affiliated corporations, with due regard to California's budgetary constraints, with fairness to all affected taxpayers, and in deference to federal governmental concerns regarding the state's use of worldwide combined reporting.

SUMMARY OF ARGUMENT

The Tenth Amendment to the United States Constitution guards against undue federal interference with certain core state functions. No function of state government is more essential to its sovereignty than the administration and collection of taxes. California has enacted a fairly apportioned, nondiscriminatory corporate franchise tax that is applied equally to all unitary businesses. The apportionment formula used to calculate the state tax results in a determination of the amount of income that is fairly attributable to the business activities in California of a unitary business, regardless of where the balance of the unitary business may be located.

The imposition of this fairly apportioned, nondiscriminatory tax by California on corporations doing business in California does not impair federal rights to regulate foreign commerce or impact upon the federal government's ability to speak with "one voice" with regard to foreign affairs. The Congress of the United States alone holds the power to regulate commerce with foreign nations. The President of the United States holds the power to make treaties with the advice and consent of the United States Senate. However, the Congress has deliberately and repeatedly refused to prohibit the use by the States of worldwide combined reporting as a means of determining the tax liability of unitary businesses with both foreign and domestic commercial activities. In addition, no treaty has been made by the President that would prohibit the use of worldwide combined reporting in connection with the state taxation of those unitary businesses.

Finally, the California Legislature has consistently identified the concerns of the federal government and the domestic and international business communities with regard to California's use of worldwide combined reporting and has revised and recast California's corporate franchise tax law in a conscientious effort to address those concerns.

ARGUMENT

I. THE POWER TO TAX IS AN INHERENT RIGHT OF THE STATE OF CALIFORNIA AND ITS EXERCISE MAY NOT BE LIMITED BY MERE IMPLICATION; NO FEDERAL CONSTITUTIONAL PROVISION PROHIBITS THE USE OF WORLDWIDE COMBINED REPORTING, THUS, THE EXERCISE HERE OF THE SOVEREIGN RIGHT OF CALIFORNIA TO TAX IS PROPER

A. The Tenth Amendment Ensures California's Sovereignty, Thereby Creating a Dual System of Sovereignty Between California and the Federal Government Under Which Neither Entity May Impair the Sovereignty of the Other

The Tenth Amendment to the United States Constitution provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people." The thrust of this constitutional provision is that the States are not mere political subdivisions of the United States. Instead, the several States retain a residuary and inviolable sovereignty. *New York v. United States*, 505 U.S. ___, 120 L. Ed. 2d 120, 158 (1992). In recognition

of this sovereignty, the Constitution confers upon Congress the power to regulate individuals, not States. Consequently, although Congress is granted the power to regulate commerce, it lacks the power to directly compel the States to regulate commerce. *Id.*, 120 L. Ed. 2d at p. 144.

As this Court recently recognized, "[t]he States retain substantial sovereign authority under our constitutional system." *Gregory v. Ashcroft*, 501 U.S. ___, 115 L. Ed. 2d 410, 422 (1991). Although Congress may legislate in areas traditionally regulated by the states pursuant to the Supremacy Clause, Congress does not exercise that power lightly. "[O]ur Constitution establishes a system of dual sovereignty between the States and the Federal Government," *Id.* (115 L. Ed. 2d 410, 421), for it is "founded upon the total or partial incorporation of a number of distinct sovereignties." Alexander Hamilton, *The Federalist No. 82*, p. 458 (I. Kramnick ed., 1987). "[T]he Court's consistent understanding" is that " '[t]he States unquestionably do retai[n] a significant measure of sovereign authority . . . to the extent that the Constitution has not divested them of their original powers and transferred those powers to the Federal Government.' " *New York v. United States*, 505 U.S. ___, 120 L. Ed. 2d 120, 137 (1992), quoting *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 549, 83 L. Ed. 2d 1016, 1033 (1985). Almost 70 years ago, this Court discussed the tension between state and federal taxing powers as follows:

> "[N]either government may destroy the other nor curtail in any substantial manner the exercise of its powers. Hence, the limitation upon the taxing power of each, so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other; and that limitation cannot be so varied or extended as seriously to impair either the taxing power of the government imposing the tax (*South Carolina v. United States*, 199 U. S. 437, 461, 50 L. ed. 261, 269, 26 Sup. Ct. Rep. 110, 4 Ann. Cas. 737; *Flint v. Stone Tracy Co.* 220 U. S. 172, 55 L. ed. 421, 31 Sup. Ct. Rep. 342, Ann. Cas. 1912B, 1312) or the appropriate exercise of the functions of the government affected by it (*Union P. R. Co. v. Peniston*, 18 Wall. 31, 21 L. ed. 791)." *Metcalf & Eddy v. Mitchell*, 269 U.S. 514, 523, 70 L. Ed. 384, 392 (1926).

In *EEOC v. Wyoming*, 460 U.S. 226, 75 L. Ed. 2d 18 (1983), this Court (in both its majority and dissenting opinions) reaffirmed the importance and vitality of constitutional principles of federalism in analyzing Congress's exercise of its powers under the Commerce Clause. The majority in that case, speaking through Justice Brennan, concluded that the principles of federalism embodied in the Tenth Amendment did not bar application of the Age Discrimination in Employment Act of 1967 to a State's game wardens. The Court nevertheless emphasized that the Tenth Amendment guards against "undue federal interference in certain core state functions" and ensures the "unique benefits of a federal system in which States enjoy a 'separate and independent existence.' " *Id.*, 460 U.S. at p. 236, quoting, in part, *Lane County v. Oregon*, 74 U.S. (7 Wall.) 71, 76, 19 L. Ed. 101, 104 (1869).

B. The Power to Tax is at the Core of California's Sovereignty and May Not be Interfered With by the Federal Government in the Absence of a Direct and Substantial Interference With a Federal Power

The power to tax is essential to the very existence of state government and may be exercised to the utmost

extent, limited only by the structure of the government itself. *M'Culloch v. The State of Maryland et al.*, 17 U.S. (4 Wheat.) 316, 428, 4 L. Ed. 579, 607 (1819). The power to tax is not confined to the people or property of a State, but may be exercised with respect to every object brought within a State's jurisdiction. *Id.*, 17 U.S. (4 Wheat.) at p. 429; *Harvester Co. v. Dept. of Taxation*, 322 U.S. 435, 444-45, 88 L. Ed. 1373, 1381 (1944).

Thus, no function of state government goes more to the core of its sovereignty than the power to tax. See, e.g., *Bode v. Barrett*, 344 U.S. 583, 585, 97 L. Ed. 567, 571 (1953). Federal interference with that function, whether by the courts or Congress, has limitless potential to disrupt the operation of state governments.[1] Accordingly, this Court has long recognized "the important and sensitive nature of state tax systems and the need for federal-court restraint when deciding cases that affect such systems." *Fair Assessment in Real Estate Assn. v. McNary*, 454 U.S.

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[1] If this Court retroactively prohibits the use of worldwide combined reporting, as urged by petitioners, it is estimated that the State of California will lose $4.0 billion in revenue. That amount represents disputed taxes collected or collectable over the past three decades. However, if the disputed taxes are refunded in a single year as a result of a decision adverse to respondent, they would represent approximately 8 percent of the State's 1993-94 annual state budget of $52.1 billion. Ch. 55, Cal. Stats. 1993. Since 1977, the last tax year (income year) at issue here, the State of California has experienced deficits in 12 of the succeeding 16 years. California Legislative Analyst's Office *CAL Facts* (May 1993), p. 29 [Appendix A]. As a result of these shortfalls in revenue, the loss of 8 percent of the state budget would seriously threaten California's fiscal stability and would force further budget reductions in essential public services.

100, 102, 70 L. Ed. 2d 271, 274 (1981); see also *United States v. California*, 507 U.S. ___, 123 L. Ed. 2d 528 (1993); *Great Lakes Co. v. Huffman*, 319 U.S. 293, 87 L. Ed. 1407 (1943); *Mathews v. Rodgers*, 284 U.S. 521, 76 L. Ed. 447 (1932); *First Natl. Bank v. Weld County*, 264 U.S. 450, 68 L. Ed. 784 (1924). Over a century ago in *Dows v. City of Chicago*, 78 U.S. (11 Wall.) 108, 20 L. Ed. 65 (1871), this Court was confronted with a question of whether a State should be enjoined from collection of a tax even if it is conceded that the tax is illegal. In exercising judicial restraint by denying equitable relief, this Court stated:

> "It is upon taxation that the several States chiefly rely to obtain the means to carry on their respective governments, and it is of the utmost importance to all of them that the modes adopted to enforce the taxes levied should be interfered with as little as possible. Any delay in proceedings of the officers, upon whom the duty is devolved of collecting taxes, may derange the operations of government, and thereby cause serious detriment to the public." *Dows v. City of Chicago*, 78 U.S. (11 Wall.) 108, 110, 20 L. Ed. 65, 66 (1871).

A State's power to tax is not derived from the Constitution of the United States, but exists independently therefrom. *Railroad Company v. Peniston*, 85 U.S. (18 Wall.) 5, 29, 21 L. Ed. 787, 791 (1873). The sole constitutional provision restricting the State's power to impose taxes is the general prohibition upon the laying of imposts or duties on imports or exports. U.S. Const., Art. I, Sec. 10; *Railroad Company v. Peniston*, supra, 85 U.S. (18 Wall.) at p. 29. Neither petitioner claims that this constitutional provision is implicated here.

Although a State may not levy taxes that directly hinder the exercise of any power that belongs to the federal government, a state tax that only remotely affects the efficient exercise of a federal power is, for that reason alone, not prohibited by the Constitution. *Id.*, 85 U.S. (18 Wall.) at p. 30. Thus, unless it is clearly shown that there is some particular, direct, and substantial, and not merely an incidental or gratuitous, interference with a federal right, a State, is free to exercise its taxing power. *Shannon v. Streckfus Steamers*, 279 Ky. 649, ___, 131 S.W. 2d 833, 838 (1939). Moreover, a State's power to tax may not lightly be stricken down on the basis of mere implication. *Great Lakes Dredge & Dock Co. v. Charlet*, 134 F. 2d 213, 216 (5th Cir., 1943), affd. *Great Lakes Co. v. Huffman*, 319 U.S. 293, 87 L. Ed. 1407 (1943).

Section 27 of Article XIII of the California Constitution expressly permits the California Legislature to "tax corporations, including State and national banks, and their franchises by any method not prohibited by this Constitution or the Constitution or laws of the United States." Accordingly, in the absence of a direct and substantial interference with a federal power, the State's power to tax cannot be circumscribed by the federal government.

Petitioner Barclays Bank PLC ("Barclays") asserts that there is international objection to the use of worldwide combined reporting. Brief for Petitioner Barclays, at pp. 6-7. However, the national policy established by the Congress and the federal Executive clearly permitted the use of worldwide combined reporting during the tax years (income years) in dispute. See Argument III B, infra, at pp. 19-24. Thus, the assertion of Barclays does

not establish a direct and substantial interference with any federal power and, consequently, the power of the California Legislature to impose taxes in the manner at issue here may not be limited.

C. If Congress Perceives that California's Exercise of Its Power to Tax is Impinging upon Congressional Power to Regulate Foreign Commerce, then Congress Is the Proper Body to Limit California's Power to Tax

Rather than this Court imposing judicially constructed restraints on the power of States to impose taxes, Congress is in the best position to act to restrict or curtail state powers to tax based on any perceived intrusion into Congress' power with respect to foreign commerce. However, in the period of a decade and a half since Barclays filed its return for the tax year at issue, Congress has deliberately chosen not to limit the State's power to use worldwide combined reporting despite the introduction of various federal legislative proposals to limit that power. See discussion in Argument III A, infra, at pp. 18-19.

II. THE TAX IMPOSED BY CALIFORNIA ON CORPORATIONS THAT DO BUSINESS IN THE STATE, INCLUDING CORPORATIONS WITH FOREIGN AFFILIATES, IS FAIRLY APPORTIONED AND NOT DISCRIMINATORY

Formulary apportionment has been approved for more than a century as a means of fairly dividing a single tax burden among several jurisdictions in which a taxpayer does business. See *State Railroad Tax Cases*, 92 U.S. 575, 23 L. Ed.

663 (1875). The Constitution imposes no single formula on the States. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164, 77 L. Ed. 2d 545, 552 (1983). California's three-factor formula of property, payroll, and sales was approved by this Court over a half century ago, *Butler Bros. v. McColgan*, 315 U.S. 501, 86 L. Ed. 991 (1942), and has become a benchmark against which other apportionment formulas are measured. *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 380-381, 112 L. Ed. 2d 884, 909 (1991), citing *Container Corp. v. Franchise Tax Bd.*, supra, at p. 170; see *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 284, 57 L. Ed. 2d 197, 210 (Blackmun, J., dissenting) (1978).

Petitioners do not make any claim before this Court that the tax imposed on them using formulary apportionment is not a fairly apportioned tax. Petitioners primarily object to the mechanical means of determining their tax: worldwide combined reporting. Specifically, petitioners assert that multinational corporations are entitled to determine their tax in a manner different from wholly domestic unitary enterprises doing business in California because petitioners are each a part of a unitary business that has a structure that includes a foreign affiliate.

The essence of Barclays' assertions is that it should be treated differently because one of its foreign affiliates is the parent corporation, Brief for Petitioner Barclays, at p. 3. However, a differential means of taxation based on whether a corporation has a foreign or domestic domicile would violate the foreign commerce clause. See *Kraft Foods v. Iowa Dept. of Rev.*, 505 U.S. ___, 120 L. Ed. 2d 59, 67 (1992). Moreover, the exploitation by foreign corporations of intrastate opportunities under the protection and encouragement of local government offers a basis for taxation as unrestricted as that for domestic corporations. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623, 69 L. Ed. 2d 884, 898 (1981). This Court has made clear that the Commerce Clause does not relieve foreign corporations from paying their just share of the state tax burden even though it increases the cost of doing business, because to do so would be to place those corporations in a privileged position. *Id.*, 453 U.S. at pp. 623-624.

Petitioner Colgate-Palmolive Company ("Colgate") makes a similar claim based on the inclusion of its foreign subsidiary corporations, Brief of Petitioner Colgate, at p. 47, even though this Court has previously rejected an identical claim. Specifically, this Court has previously concluded that California's application of the unitary business principle and the three-factor formula to a domestic corporation with overseas subsidiaries was proper and not unconstitutional. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 184, 77 L. Ed. 2d 545, 565 (1983). More importantly, this Court took note of, and approved, the worldwide combined reporting method used to determine the tax owed by the unitary group in that case. *Id.*, 463 U.S. at pp. 174-175.

Even though Barclays claims that the method of taxation imposes a discriminatory compliance burden, the California Court of Appeal found that the compliance burden was not unconstitutional because California required the same information from all taxpayers. *Barclays Bank Internat. Ltd. v. Franchise Tax Bd.*, 10 Cal. App. 4th 1742, 1753-1756. Under the method employed in California, the amount of tax owed is the same regardless of whether the parent corporation of a group of corporations that operate as a unitary business is located in California, in another State, or in a foreign country. See Cal. Rev. & Tax. Code Sec. 25101. The tax calculation is

neutral in that respect, and clearly nondiscriminatory. The location of the parent corporation is irrelevant to the tax calculation and has no bearing upon what records are required or must be maintained in order for that portion of the unitary business that does business in California to file a tax return or combined report in California. The only information a taxpayer needs with regard to its unitary business is a record of its business income, property, payroll, and sales. Cal. Rev. & Tax. Code Sec. 25128.

Each corporation that does business in California is required to file a tax return. Cal. Rev. & Tax. Code Sec. 25401. In addition, corporations doing business in California that are part of a unitary business are required to file a combined report. Cal. Rev. & Tax. Code Sec. 25101.

The problem inherent in taxing a multinational unitary business is that there is a single worldwide business, and in some fashion a jurisdiction, such as California, must fairly apportion the business income of that unitary business to the jurisdiction in order to determine a tax upon that income. Petitioners do not claim that either of them is other than a part of a unitary business. The existence of a unitary business indicates that there are economies of scale and transfers of value among the affiliated corporations. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 166, 77 L. Ed. 2d 545, 554 (1983).

To determine a fair tax, California must determine what portion of business activity is fairly attributable to California. Implicitly, where there is a unitary business there is some single entity that is a part of that business that has a record of the value of the whole business. Under the method employed in California, the tax rate is

applied to that portion of the net income that is attributable to the business in California. The amount of business activity attributable to California is measured by determining the proportion that the property, payroll, and sales in the State of the unitary business bears to the total of the property, payroll, and sales everywhere of the unitary business. Cal. Rev. & Tax. Code Sec. 25128.

Thus, as the calculation is applied to any unitary business that does business within the State of California, the calculation is blind as to where the parent corporation of the group is located.[2] The parent corporation may be located in California, elsewhere in the United States, or in another country. As among the members of the unitary group, it is immaterial who maintains sufficient data to make the calculation of business activity attributable to the State of California, and it is immaterial where that data is maintained. It is sufficient that the tax records of the unitary business are maintained by some member of the group, whether it be a subsidiary located in California, a subsidiary located elsewhere, a parent corporation located in California, or a parent corporation located anywhere in the world.

Moreover, use of the California three-factor formula is well-established, *Butler Bros. v. McColgan*, 315 U.S. 501, 509, 86 L. Ed. 991, 997 (1942), and does not result in a

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[2] In fact, the parent corporation may not even be a part of the unitary business. There may well be examples of unitary groups in which there is no integration between the parent corporation and the unitary business that does business in California. In that instance, the formula would exclude any factors, or value, of the parent corporation from the calculation of the tax.

"novel state tax" that carries a risk of asymmetry in the international tax structure. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194-195, 77 L. Ed. 2d 545, 572 (1983). Although Barclays asserts that automatic asymmetry results, Brief for Petitioner Barclays, at pp. 28-29, that is clearly not the case. Using the three-factor formula as a means of apportioning business income, a foreign multinational that has the same portion of its business activity in California as a domestic multinational will pay the same tax.

Petitioners seek to circumscribe a method of fairly apportioning taxes that has been successfully used by states for over a century. Barclays bases its rationale upon an assertion that the foreign parent corporation within its unitary business objects to the imposition of a fairly apportioned tax upon corporations that do business within the State of California. Brief for Petitioner Barclays at pp. 11-12. The implication of that assertion is that a unitary business that does business in California ought to be accorded special treatment if the unitary business has a parent corporation that is located in a foreign country.[3]

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[3] It is clear that domestic subsidiary corporations of a foreign parent corporation are not entitled to any special treatment under a treaty with the national government of the foreign parent. *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176, 188-189, 72 L. Ed. 2d 765, 774-775 (1982). The logical corollary to this holding is that in absence of an express treaty provision both foreign and domestic corporations doing business in a jurisdiction within this country should be treated alike. In accordance with this principle, California applies the same formulary apportionment method to all unitary businesses regardless of the place of their incorporation.

The California Legislature believes that its power ought not to be curtailed where it has merely imposed a tax on activity within the borders of the State of California. The imposition of a tax on discrete activity in California of corporations doing business within the state does not, in and of itself, implicate foreign affairs. The controversy arises in this case from the methodology used to measure California activity that takes into consideration worldwide activity in order to derive a measure of activity within California. The mere fact that this controversy may have arisen in an international context because a multinational corporation objects to the particular method that California and other States in this nation use to apportion income to each State does not, by itself, establish that the method impinges on the exclusive federal power concerning the conduct of foreign affairs.

The State of California, acting through its Legislature, has a sovereign right to impose nondiscriminatory, fairly apportioned taxes on corporations doing business within the State's borders. No federal constitutional provision prohibits the use of worldwide combined reporting. Thus, the exercise here of the sovereign right of California to tax is proper. Corporations that engage in business in more than one jurisdiction are not immune from paying a fair state tax. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 277, 51 L. Ed. 2d 326, 330 (1977). Accordingly, the California Legislature should continue to be permitted to impose fairly apportioned and nondiscriminatory taxes on any unitary business that does business in California without regard to where outside of California the affiliated corporations of the unitary business are located.

III. CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO PETITIONERS WITH RESPECT TO THE TAX YEARS AT ISSUE DID NOT PREVENT THE FEDERAL GOVERNMENT FROM SPEAKING WITH ONE VOICE WHEN REGULATING RELATIONS WITH FOREIGN GOVERNMENTS; RATHER, THE EFFORTS OF THE CALIFORNIA LEGISLATURE IN ENACTING LAWS RELATING TO WORLDWIDE COMBINED REPORTING HAVE BEEN ENTIRELY CONSISTENT WITH FEDERAL POLICY AND HAVE ADDRESSED SPECIFIC CONCERNS RAISED BY THE FEDERAL GOVERNMENT AND MULTINATIONAL CORPORATIONS

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 51 L. Ed. 2d 326 (1977), this Court adopted a four-part test to determine whether a state tax is valid against a Commerce Clause challenge: specifically, the tax must be applied to an activity with a substantial nexus with the taxing State; it must be fairly apportioned; it must not discriminate against interstate commerce; and it must be fairly related to the services provided by the State. *Id.*, 430 U.S. at p. 279.

When foreign commerce is at issue, this Court has held that, in addition to the four-part test, the tax must not create a substantial risk of international multiple taxation, and it must not prevent the federal government from speaking with one voice when regulating relations with foreign governments. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450, 60 L. Ed. 2d 336, 349. This Court has held that a state tax at variance with federal policy will violate the "one voice" standard if it either implicates foreign policy issues which must be left to the

federal government or violates a clear federal directive. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194, 77 L. Ed. 2d 545, 571-572 (1983). In that case, this Court decided that if a state tax merely has foreign resonances, but does not implicate foreign affairs, the Court cannot infer, absent some explicit directive from Congress, that treatment of foreign income at the federal level mandates identical treatment by the States. *Id.*, 463 U.S. at p. 571.

Barclays asserts that worldwide combined reporting undeniably implicates foreign policy issues which must be left to the federal government and prevents the nation from speaking with one voice. Brief for Petitioner Barclays, at p. 22. Barclays has previously asserted, both in the Supreme Court of California below and in its Petition for a Writ of Certiorari, that respondent's application of formula apportionment to the unitary business of which it is a part offends the foreign Commerce Clause because it violates a clear federal directive that is embodied in an array of federal Executive communications. *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 726 (1992); Petition for Writ of Certiorari by Petitioner Barclays, at pp. 17 to 20, incl. Barclays now asserts in its opening brief that the use of a method of state taxation other than the arm's length method frustrates United States policy, and that the use of worldwide combined reporting results in the clearest foreign policy implication, namely, the risk of foreign retaliation. Brief for Petitioner Barclays, at pp. 22, 25. Colgate makes similar assertions. Brief of Petitioner Colgate, at pp. 6, 16, 17, 32 to 36, incl.

Petitioners' assertions ignore, among other things, that Congress has deliberately and repeatedly refused to enact a prohibition on the use of worldwide combined reporting by the States, and that the California Legislature has undertaken conscientious efforts to respond to the concerns of both the federal government and multinational corporations in connection with the State's modification of worldwide combined reporting. Moreover, petitioners' assertions are not consistent with the constitutional grant of authority provided by the Commerce Clause and misconstrue what the federal policy was during the tax years at issue in these cases.

A. Congress has Deliberately and Repeatedly Refused to Prohibit the Use of Worldwide Combined Reporting by the States

In 1978, the United States Senate specifically rejected article 9(4), as originally negotiated, in a bilateral tax treaty with the United Kingdom that would have disallowed worldwide combined reporting by the States. See Remarks of Senators Cranston, Javits, and Pell, 124 Cong. Rec. 18400, 19076 (1978). Significantly, this treaty was ratified by the United States Senate only after that provision was removed. *Ibid.* These facts, along with Congressional rejections of a number of federal legislative proposals with similar prohibitory provisions, were best summarized by the Supreme Court of California below, as follows:

> "The Senate's action with respect to article 9(4) is only the most explicit example of a persistent congressional refusal to enact curbs on

> the states' use of worldwide formula apportionment reaching back well before 1977, the tax year at issue in this case. The parties agreed in a pretrial stipulation that 'various proposed Legislative bills have been introduced in the United States Congress that would, among other things, affect the states' use of worldwide combined reporting.' The stipulation identifies twenty such House and Senate bills spanning twenty years. These range from House Resolution No. 11798 introduced in the House in 1965 (an ambitious 'Interstate Taxation Act' that would have required the states to adopt a two-factor apportionment formula in taxing unitary groups) to 1985 legislation sponsored by the Treasury Department that would have limited state use of worldwide formula apportionment to members of foreign-based corporate groups actually doing business in the United States, that is, so-called 'water's edge' legislation. (See *post*, pp. 739-740.) None of these measures was enacted into law by Congress." *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 736 (1992).

B. The California Legislature has Responded Appropriately to the Concerns of both the Federal Government and Multinational Corporations

In 1983, shortly after this Court's decision in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 77 L. Ed. 2d 545 (1983), the federal government announced plans to establish a working group composed of representatives of the federal government, state governments, and the business community to produce recommendations "that will

be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." Chairman's Report and Supplemental Views, Final Report of the Worldwide Unitary Taxation Working Group (Aug. 1984), Office of the Secretary, Department of the Treasury.

The final report of the working group, released in 1984, made recommendations for the states to mitigate the international effects of formula apportionment, including limiting its use to the "water's edge" (whereby certain affiliated entities of a unitary group are excluded from the unitary tax base). *Id.*, at p. iii.

The report stated that if states enact legislation based on the three principles agreed upon by the Working Group ((1) water's edge unitary combination for both U.S. and foreign based companies, (2) increased federal administrative assistance and cooperation with the States to promote full taxpayer disclosure and accountability, and (3) competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses), the United States will be able to speak with one voice in dealing with its foreign trading partners. *Ibid.*

In response to the recommendations of the Chairman's Report, the California Legislature in 1986 enacted Senate Bill No. 85 (Ch. 660, Cal. Stats. 1986), which authorized a water's edge election for tax years beginning on or after January 1, 1988.[4] Specifically, S.B. 85 allowed a

[4] Thus, the assertion by one of amicus curiae supporting petitioners, that California currently uses "forced" worldwide combined reporting, is flatly wrong. See Brief of the Committee on State Taxation as Amicus Curiae in Support of Petitioners, pp. 3, 4, and 7-10, incl.

qualified taxpayer, as defined, whose income is subject to the California franchise tax to determine its income derived from or attributable to sources within California pursuant to a water's edge election upon the payment of a specified election fee. Under this election, only the income and apportionment factors of certain affiliated entities (generally those located within the boundaries of the United States) would be included in the unitary tax base.

As the result, in part, of California's enactment of S.B. 85, the Honorable J. Roger Mentz, Assistant Secretary (Tax Policy) of the Department of the Treasury stated as follows:

> "I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. *These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the successful operation of the Federal system.* These and the other states that have moved away from the worldwide unitary tax system in recent years recognize that their interest, and the national interest, lies in a single, coherent approach to taxing international income that minimizes tax-related impediments to international flows of investment capital.
>
> "We have not, however, reached the end of the road with respect to this issue. Though the

economic impact is not great, three states (Alaska, Montana, and North Dakota) continue to impose tax on a worldwide unitary basis. As I will discuss below, we also have concerns regarding elements of the California legislation. *We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time.* . . . California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect.

* * *

" . . . States have moved away from the worldwide unitary method in part in reliance on the Administration's representations in this regard. To the extent possible without legislation, the Administration has already moved to provide greater assistance to the states. We continue to be committed to providing such federal support. . . .

"The progress made on this difficult issue is a tribute to the wisdom of President Reagan's decision in 1983 to seek a cooperative solution by convening a Worldwide Unitary Taxation Working Group, consisting of representatives from states, business and the Federal government, to address the issue. It is also a tribute to the leadership evidenced by the state officials and leaders of domestic and foreign-controlled multinationals that have together forged compromises in states across the country. We expect that these participants will continue to demonstrate the same leadership as we attempt to address the remaining concerns relating to the worldwide unitary tax issue." Letter from J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy) to George Deukmejian, Governor of California (April 8, 1987) (J.A. 24-27). Emphasis added.

Moreover, contrary to petitioners' assertions that California's method of taxation leads to justifiable foreign retaliation, see Brief for Petitioner Barclays, at p. 28, the evidence indicates that the business community, including foreign corporations (and specifically Barclays), contributed significantly to both the legislative process that produced the enactment of S.B. 85 and the regulatory process thereafter that implemented that legislation and, generally, received substantial unitary reform as a result of the legislative compromise that was forged. See Appendix B.

In 1993, as a part of the continuing dialogue between federal and California officials and the business community, the California Legislature enacted Senate Bill No. 671 (Ch. 881, Cal. Stats. 1993) to make substantial changes to the water's edge provisions, including, among other things, the elimination of the requirement that an election fee be paid and the authorization of a taxpayer to elect to account for and determine its income pursuant to a water's edge election for an 84-month period. S.B. 671 also deleted the previous requirement of filing a domestic disclosure spreadsheet and, instead, provided that each taxpayer required to apportion its income was to file an annual information return, as specified.[5]

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[5] It should be noted that the voluntary actions of the California Legislature in enacting water's edge legislation have come at times when the State has been facing multi-billion

Again, as in the case of S.B. 85, the California Legislature was responsive to the concerns of both the federal government and the business community, and vitually all of the unitary reforms that had been sought were enacted. See Appendix C.

Thus, it is apparent that over the years the California Legislature has exercised its sovereign power to tax with due recognition and responsible consideration of the concerns and desires of both the federal government and the business community with regard to California's use of worldwide combined reporting. At the same time, the federal government has respected the use of worldwide combined reporting by individual states in the exercise of their sovereign taxing power and, in response to complaints from multinational corporations, has instituted and adhered to a policy that requested only voluntary state action in adopting water's edge legislation.

C. Petitioners' Heavy Reliance on Federal Executive Communications as Constituting a Clear Federal Directive for Purposes of the Commerce Clause is Misplaced

The Commerce Clause of the Constitution of the United States grants the power to Congress, not the

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dollar budget deficits. For example, in 1993 the California Legislature was facing a budget deficit of over $7 billion. Nevertheless, even though future revenue collections were and remain uncertain (as of the time of this writing, a deficit of over $3.8 billion is projected for 1994), the California Legislature made the difficult choices of cutting vital programs and raising various other taxes, while still enacting S.B. 671.

Executive Department, to regulate foreign and interstate commerce. U.S. Const., Art. I, Sec. 8, cl. 3. Therefore, any action of Congress with respect to foreign commerce is certainly more determinative of federal policy in that regard than any desire or aspiration that may be expressed by individual representatives of the federal Executive. See *U.S. v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 81 L. Ed. 255 (1936); *United States v. Guy W. Capps, Inc.*, 204 F. 2d 655, 658-660 (4th Cir. 1953), aff'd on other grounds, 348 U.S. 296, 99 L. Ed. 29 (1955).

Barclays' misplaced reliance on federal Executive communications as determinative of federal policy is also demonstrated in its criticism of the decision of the Supreme Court of California below, as follows:

> "The 'one voice' test proceeds from the strong presumption of the need for federal uniformity in the area of foreign commerce. *Japan Line*, 441 U.S. 434; *Wardair*, 477 U.S. 1. The decision of the court below sees no need for uniformity. Rather it invites state interference in foreign affairs unless Congress curbs the state. The California court would silence the Executive and in the silence of Congress permit a cacophony of state voices. Who can tell our foreign trading partners what the policy of the United States is? Can our foreign trading partners rely upon the responses of the Executive? Is this not exactly the situation which will lead to retaliation and harm to the nation as whole?" Petition for Writ of Certiorari by Petitioner Barclays, at p. 24. Footnote omitted.

Barclays' questions can be answered, in part, by posing the following question: Under our federal constitutional system, does the Executive Department have the authority to either enact a statute that would ban the use

of worldwide combined reporting by the States without Congressional approval, or to make a treaty that would ban the use of worldwide combined reporting by the states without obtaining the advice and consent of, and the concurrence of two-thirds of the membership of, the Senate? The answer obviously is no.

Even if it is conceded that the federal Executive has some measure of authority in this area, the federal Executive in fact has chosen only to request voluntary action by the States in enacting water's edge legislation to address the concerns expressed by some members of the business community. See, e.g., Chairman's Report and Supplemental Views, Final Report of the Worldwide Unitary Taxation Working Group (Aug. 1984), Office of the Secretary, Department of the Treasury; Letter from J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy) to George Deukmejian, Governor of California (April 8, 1987) J.A. 24-27.

D. Petitioners' Assertion That Worldwide Combined Reporting is Prohibited by Dormant Commerce Clause Analysis is Incorrect

Barclays sets out a number of events, most of which are subsequent to the enactment of Senate Bill No. 85 in 1986, and many of which occurred as recently as 1993, that disclose dissatisfaction or risk of retaliation by foreign governments. Brief for Petitioner Barclays, at pp. 10, 11. The only significant event preceding the enactment of Senate Bill No. 85 to which Barclays refers is the "retaliatory" legislation enacted in the United Kingdom in 1985. Barclays asserts that this legislation is the most obvious

foreign policy implication. Brief for Petitioner Barclays, at p. 27.

In response to petitioners' assertions regarding the risk of retaliation, amicus curiae submits that the fact that the United Kingdom negotiated and accepted the bilateral treaty which specifically excluded article 9(4), as originally negotiated, weighs strongly against the conclusion that the tax imposed by California might *justifiably* lead to significant foreign retaliation. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194, 77 L. Ed. 2d 545, 572 (1983).

Barclays also relies on a number of events occurring subsequent to 1977, the latest tax year at issue, and purports to extrapolate therefrom a precise federal foreign policy that was in effect both prior to and during 1977: specifically, that the use of the arm's length method was required to be used by California. Brief for Petitioner Barclays, at pp. 5, 8, 23 to 25, incl. Pursuant to Barclays' reasoning, that policy is discerned through a dormant Commerce Clause analysis. Colgate makes a similar argument. Brief of Petitioner Colgate, at pp. 34, 35, 36, 40, 41, 42.

In this connection, petitioners assert both that the use of the arm's length standard was a critically important feature of foreign policy and that Congress took no action during the tax years at issue or in subsequent years, with respect to that precise and important foreign policy. Brief for Petitioner Barclays, at pp. 19 to 25, incl.; Brief of Petitioner Colgate, at pp. 6, 19 to 22, incl. If petitioners' claim of inaction by Congress is accepted, an interesting question is presented: If the specific foreign policy asserted by petitioners was so pressing and important,

why didn't Congress take any legislative action to ensure that the policy was implemented by the States?

The apparent contradiction raised by this question can be resolved rather simply. Congress *did* actually take action with respect to federal foreign commerce policy as it relates to worldwide combined reporting.

In this connection, amicus curiae submits that the fact that Congress has rejected various federal legislative proposals affecting the use of worldwide combined reporting by the states over a 20-year period commencing in 1965, see *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 736, and the fact that a bilateral treaty was being negotiated at or about the time of the tax years in question, and that these negotiations were followed by the specific rejection of article 9(4), as originally negotiated, thereof by the United States Senate in 1978, see Remarks of Senators Cranston, Javits, and Pell, 124 Cong. Rec. 18400, 19076 (1978), make clear what federal foreign policy was for the tax years in question, irrespective of what that policy arguably may be currently. That policy was to not prohibit the continued use of worldwide combined reporting by the States.

For the foregoing reasons, amicus curiae submits that petitioners' assertion that worldwide combined reporting is prohibited by the inaction of Congress and dormant Commerce Clause analysis is incorrect.

E. The Application of Worldwide Combined Reporting to Petitioners Was Proper

The State of California, acting through the California Legislature, has exercised its sovereign power to tax

responsibly and with due deference to federal policy. The California Legislature recognizes that formulary apportionment has been approved for more than a century as a means of fairly dividing a single tax burden among several jurisdictions in which a taxpayer does business. The California Legislature recognizes that the Constitution grants to Congress, not the federal Executive, the power to regulate foreign and interstate commerce. The California Legislature is aware of the fact that Congress has specifically and continuously rejected any federal legislative ban on the use of worldwide combined reporting by the States.

The California Legislature is keenly aware of federal foreign commerce policy, and through California's large Congressional delegation, the State of California has contributed significantly to the formulation of that policy.

At the same time, the California Legislature is aware that federal policy can and does evolve over time. In this regard, the California Legislature has been closely attuned to the desires and concerns expressed by the federal Executive and the business community as exemplified by, among other things, the enactment in California of Senate Bill No. 85 and Senate Bill No. 671. However, the California Legislature believes that no foreign nation or corporation may dictate how the United States may conduct its foreign policy or how a State may conduct its sovereign power to tax.

Accordingly, amicus curiae submits that California's application of worldwide combined reporting to petitioners for the tax years at issue did not prevent the federal government from speaking with one voice when

regulating relations with foreign governments. Rather, the efforts of the California Legislature in enacting laws relating to worldwide combined reporting have been entirely consistent with the evolution of federal policy in this area, and have addressed specific concerns raised by the federal government and multinational corporations during that period of evolution.

CONCLUSION

For the foregoing reasons, amicus curiae urges this Court to affirm the decisions of the Court of Appeal of the State of California, Third Appellate District.

Respectfully Submitted,

BION M. GREGORY*
Legislative Counsel of
California

JAMES A. MARSALA
Principal Deputy
Legislative Counsel

BALDEV S. HEIR
MICHAEL R. KELLY
Deputies Legislative Counsel

Attorneys for Amicus Curiae
*Counsel of Record

APPENDIX A

To President Clinton from Senate Democrats

We want to take this opportunity to thank you for your past support of California's position in the Barclays Bank PLC tax case, which is before the U.S. Supreme Court. Despite an amicus curiae brief from the Solicitor General urging the Court not to take the case, the Court has decided to hear Barclays, as well as the related Colgate-Palmolive case. California is again turning to you for support.

Should the Supreme Court decide in favor of both Barclays and Colgate-Palmolive, California stands to lose $4 billion in tax revenues. You repeatedly have stated your belief that as long as California's economy is stalled in recession, the United States cannot truly emerge into prosperity. While we believe the California economy is on the road to recovery, the loss of $4 billion in tax revenue would be devastating to the state's coffers and the state's economy.

In the closing month of this year's legislative session, California made major concessions to the multinationals and their respective governments by amending the tax code to address their concerns. These steps were undertaken in a spirit of cooperation with your Administration. These changes along with significant modifications in the workers' compensation and other business tax areas were all part of our concerted effort to assure that California's recovery can become a reality.

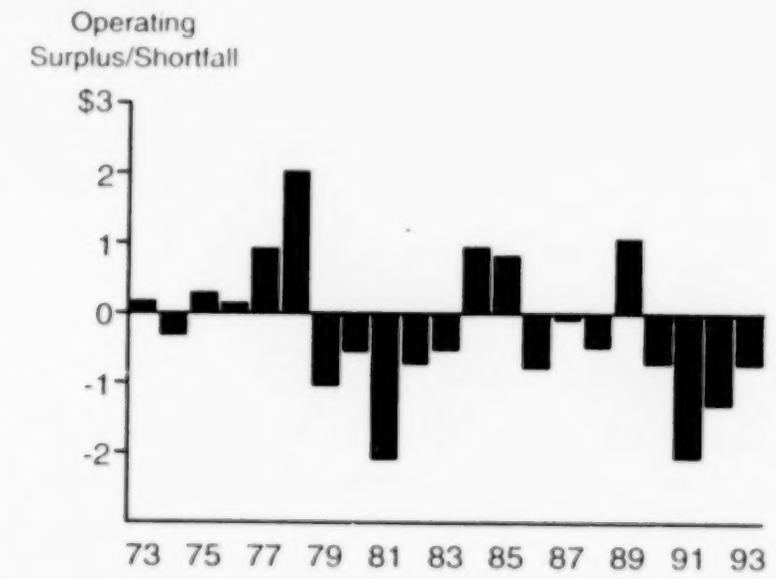
Your prior support of California on Barclays demonstrates your understanding of the need to protect the

taxing prerogatives of the states. It is vital that your Administration take an active role in supporting California before the Supreme Court. We urgently request that the Solicitor General be instructed to file an amicus brief in support of California in this matter. The deadline for filing briefs in support of California is January 14, 1994.

California's economy – and that of the nation – is in jeopardy. We need your help in order to prevail in this vital matter.

General Fund Operating Shortfalls Have Been Common In Recent Years[a]

(In Billions)



[a] Data are for fiscal years ending in year shown.

- Since Proposition 13 was approved in 1978, state General Fund spending has exceeded revenues in all but 3 years.
- 1992-93 will be the fourth consecutive year of operating shortfalls, resulting in an estimated 1992-93 ending budget deficit of $3.4 billion (absent corrective action).
- Operating shortfalls occurred even during the economic expansion of the mid-1980s.
- The relative size of the shortfalls has shrunk. The $2.1 billion 1980-81 shortfall was 9.9 percent of spending, but the $2.1 billion 1990-91 shortfall was only 5.1 percent of spending.

APPENDIX B

CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION

Governmental Relations Office • 1127 11th St., Ste., 346 • Sacramento, CA 95814 • (916) 444-0598

March 17, 1986

TO: Assemblyman John Vasconcellos, Chairman and Members of the Assembly Ways and Means Committee

RE: SB 85 (Alquist) - OPPOSE

The California School Employees Association regretfully must oppose SB 85, to repeal the unitary method of taxation [sic]. This measure is scheduled to be heard in your committee on Wednesday, March 19.

SB 85 will result in substantial tax breaks for multinational corporations, resulting in decreased revenues to the state. Combined with the impact of Gramm-Rudman the state will suffer from severe revenue losses and our experience leads us to the conclusion that our members will suffer. Not only will we suffer from reduced funding to schools which may cost us jobs, we could also be forced to pick up the slack by paying future tax increases.

All the data we have reviewed leads us to the conclusion that the repeal of the unitary tax will not substantially increase investment in California. California has led the nation in new investment despite the existence of the unitary taxation method.

We therefore urge your "NO" vote on SB 85.

Sincerely,

CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION

/s/ Dave Low SR
Dave Low
Governmental Relations Representative

DL/sb
cc: Samuel Yockey
Legislative Analyst
THE NATION'S LARGEST CLASSIFIED SCHOOL EMPLOYEE ASSOCIATION

CALIFORNIA FIRST BANK

[Logo]

OFFICE OF THE PRESIDENT, LOS ANGELES
616 WEST 6TH STREET, LOS ANGELES, CALIFORNIA 90017
(213) 972-5260

YOSHIAKI SHIBUSAWA
EXECUTIVE VICE PRESIDENT

March 22, 1985

The Honorable William P. Baker
3013 State Capitol
Sacramento, CA 95814

Dear Mr. Baker:

I wish to thank you once more for taking time from your busy schedule to discuss the unitary tax reform bills. As you know, California First Bank is most concerned about the provision in the bills which deal with

the inclusion or exclusion of foreign banks from the "water's edge" group. I very much appreciated your willingness to listen to our point of view on this issue and, if I may, I would like to take this opportunity to reiterate it in writing.

The provision in the August 28, 1984 draft of Senator Alquist's SB 1437 concerning this issue is:

> "[A taxpayer shall include the following entities in the water's edge group] . . . (7) Any affiliated bank or corporation, regardless of the place where it is incorporated, if more than 20% of its payroll, property or sales is assignable to a location within the United States."

If a foreign bank exceeds this 20% threshold, then its U.S. subsidiary would be required to include the foreign bank in a unitary tax return for the water's edge group and thus the U.S. subsidiary would *not* benefit under the proposal. The Bank of Tokyo, Ltd., the parent corporation of California First Bank will fail to be excluded from the unitary tax return of California First Bank under this threshold provision, and we request that certain technical changes be made to change this result.

For most foreign corporations, the threshold issue is not significant, because foreign corporations generally operate in the U.S. through subsidiaries and therefore have *no* direct presence in the United States. It is also relatively easy for a foreign corporation to convert a branch into a subsidiary.

The banking industry, however, is subject to unique regulatory constraints which are not imposed on corporations in general. In particular, existing bank regulatory

and licensing procedures have caused foreign banks to establish agency and branch offices in the United States. Also, it is generally not feasible to convert an agency or branch into a subsidiary. Because these agencies and branches are not separate subsidiaries, the factors of such agencies and branches in the Unites [sic] States are taken into account when applying the threshold test.

Our particular problem with the proposed threshold test is that the Bank of Tokyo, Ltd. would be included in California First Bank's unitary tax return, because currently its "sales" (gross revenues) assignable to locations within the United States may be as high as 28%. Yet the average of its payroll and property factors is only about 10%. One reason the sales factor is much higher than the other two factors is that the sales factor is inflated by the substantially higher interest rates in the United States as compared with Japan. The sales factor is also volatile, because it is impacted by currency fluctuations and changing market conditions. The technical change California First Bank requests is to change the threshold test for foreign banks. Instead of a 20% property, payroll or sales test, the test for foreign banks could be a 20% property or payroll test. This would eliminate the unpredicability [sic] of the sales factor. Alternatively, a three factor average of 20% could be used. This would at least lessen the significance of the sales factor. We also note that averaging the three factors is similar to the general formula apportionment method. The adverse effect on state revenue by making this type of technical change for the foreign banking industry should not be substantial.

Of all the Japanese-owned companies in California, California First Bank is the largest contributor to the state's employment. California First Bank employs over 4,000 California residents statewise. It would be ironic if the U.S. subsidiary with one of the largest California payrolls would be the one subsidiary which is not protected by unitary tax reform. It is also significant that 98% of all of the shareholders of California First Bank are U.S. residents (although 76.6% of the total shares are held by The Bank of Tokyo, Ltd.). It would also be ironic if the U.S. subsidiary with one of the largest groups of U.S. shareholders were not protected by unitary tax reform, since under the circumstances about 23% of the unitary tax is actually borne by those U.S. shareholders.

In summary, California First Bank requests that you support the water's edge approach developed by Senator Alquist last year (and reintroduced this year as AB No. 157 by Assemblyman Dennis Brown) with one technical modification. California First Bank requests that the threshold test be modified so that foreign banks are included within the water's edge group *only if* the property or payroll factors of the foreign bank is greater than 20% (or alternatively, only if the average of the property, payroll and sales factors is greater than 20%). California First Bank would be most appreciative of your kind and thoughtful attention to this matter.

Sincerely yours,

/s/ Yoshiaki Shibusawa
Yoshiaki Shibusawa
Executive Vice President

CASTLE & COOKE, INC. FIFTY CALIFORNIA STREET SAN FRANCISCO, CA 94111
TELEPHONE (415) 986-3000
TELEX 340295

R. D. COOK
PRESIDENT

August 21, 1985

The Honorable William Baker
Vice Chairman, Ways and Means Committee
State Capitol
Sacramento, California 95814

Dear Mr. Baker:

On behalf of Castle & Cooke, Inc., an agricultural company employing over 10,000 Californians, we assure you Unitary Tax Reform is a major concern to our company and our employees.

On August 28, 1985, as Vice Chairman of the Ways and Means Committee, you will review Unitary Tax Reform for California. All that our company and its employees request is equity.

The management of Castle & Cooke, Inc. was very concerned about what was going to happen to our 10,000 California employees while we were on the brink of bankruptcy in the spring of this year. Passage of a Unitary Tax Reform Bill which favors foreign-based companies will reverberate as a message that California legislators are not concerned about employment for these 10,000 Californians.

Senate Bill 85 will reduce the California tax expense for our foreign competitors while keeping ours at its current level. No tax benefit flows to Castle & Cooke, Inc. in SB 85 while a sizeable benefit flows to our foreign competitors.

Why would you want to provide a tax incentive to foreign-based multinationals which tips the scales of cost competitiveness even further? The huge trade imbalance with our foreign trading partners indicates no such incentive is required.

Castle & Cooke, Inc. respectfully requests that you express support for American business and vote NO on SB 85.

We would greatly appreciate hearing your thoughts on Unitary Tax Reform and if you have any questions, please let us know.

Sincerely,

/s/ R. D. Cook
R. D. Cook, President
CASTLE & COOKE, INC.

Western
Union
Mailgram [Logo]

WUTELCO
1116 12TH STREET
SACRAMENTO CA 95814 23AM

1-014827I235006 08/23/85 TWX WU PUBTLX SAC SACB
06 SACRAMENTO CA 23-AUG-85

ASSEMBLYMAN WILLIAM BAKER
ROOM 3013
STATE CAPITOL
SACRAMENTO, CA 95814

DEAR

IT SEEMS THE COMPLICATIONS SURROUNDING UNITARY TAX REFORM ARE NEVER ENDING. NOW, A NEW AND UNFORSEEN [sic], BUT MOST SIGNIFICANT PROBLEM HAS ARISEN WHICH COULD ENCOURAGE FOREIGN-OWNED CALIFORNIA BANKS TO LIMIT EXPANSION IN CALIFORNIA, REDUCE THEIR PAYROLLS AND THE NUMBER OF PEOPLE EMPLOYED. THIS WOULD, OF COURSE, BE CONTRARY TO THE INTENT OF SENATE BILL 85.

AS YOU KNOW, ON JULY 18, SB 85 WAS AMENDED TO HELP REDUCE THE TAX COMPLIANCE BURDENS OF FOREIGN BANKS WITH U.S. BRANCHES. THESE AMENDMENTS, WHILE TAKING CARE OF ONE PROBLEM, INADVERTANTLY AND IRONICALLY, CREATED ANOTHER.

VERY SIMPLY, FOREIGN-OWNED CALIFORNIA BANKS WHICH EMPLOY LARGE NUMBERS OF CALIFORNIANS, 28)) 0-6 #8&#34 '5-53 8,:9.3 5-/3' 7,ER SB IT [missing text in original] AS AMENDED, SOLELY

BECAUSE THEY EMPLOY LITERALLY THOUSANDS OF CALIFORNIANS AND HAVE, THEREFORE, SUBSTANTIAL CALIFORNIA PAYROLLS.

THIS ADDITIONAL BURDEN OCCURS BECAUSE OF STRUCTURAL FEATURES IN THE BANKING SYSTEM WHICH CANNOT BE EASILY CHANGED; PRIMARILY HIGH EMPLOYMENT FIGURES BY LARGE CALIFORNIA RETAIL BANKS AND LOW EMPLOYMENT FIGURES IN U.S. BRANCHES OF FOREIGN BANKS (PRINCIPALLY NEW YORK) WHICH DO NOT CONDUCT RETAIL BANKING. UNDER SB 85, AS AMENDED ON JULY 18, THESE U.S. BRANCHES OF FOREIGN BANKS ("DEEMED SUBSIDIARIES") WILL BE COMBINED WITH CALIFORNIA RETAIL BANKS FOR TAX PURPOSES.

JAPANESE-OWNED CALIFORNIA BANKS EMPLOY MORE THAN 100,000 CALIFORNIA RESIDENTS. AS A RESULT, THEIR CALIFORNIA PAYROLL FACTORS RANGE FROM 70-80 PERCENT WHEN CALCULATED FOR A WATER'S EDGE GROUP WHICH INCLUDES A "DEEMED SUBSIDIARY" OF A FOREIGN PARENT BANK. BUT, THE CALIFORNIA SALES AND PROPERTY FACTORS OF SUCH A GROUP WOULD BE MUCH LESS, OFTEN 20-40 PERCENT. THIS IMBALANCE WILL RESULT IN AN INCREASE IN THE CALIFORNIA TAXES OF A CALIFORNIA BANK SIMPLY BECAUSE IT EMPLOYEES [sic] A LOT OF PEOPLE AND HAS A HIGH PAYROLL FACTOR.

THIS NEW PROBLEM CAN BE SOLVED EITHER (I) BY EXTENDING THE APPLICATION OF THE 20 PERCENT AVERAGE THRESHOLD TEST CURRENTLY IN THE BILL (AND WHICH IS APPLICABLE TO FOREIGN CORPORATIONS) TO FOREIGN BANKS OR (II) BY PERMITTIG [sic] FOREIGN BANKS TO ELECT TO BE TAXED LIKE FOREIGN CORPORATIONS FOR PURPOSES OF APPLYING THE WATERD'S [sic] EDGE PROVISIONS. WE REQUEST THAT YOU CONSIDER THESE ALTERNATIVES.

1. CALIFORNIA FIRST BANK (PHONE 213-972-5260 C/O MR. SHI BUSAWA) SISHICHI ITOH, PRESIDENT.

2. GOLDEN STATE SANWA BANK (PHONE 213-614-0400) TERUYOSHI YASUFUKU, CHAIRMAN AND PRESIDENT.

3. THE MITSUBISHI BANK OF CALIFORNIA (PHONE 213-621-1200). TSUNEYOSHI KAJIWARA, PRESIDENT.

4. THE SUMITOMO BANK OF CALIFORNIA (PHONE 415-445-8151). TERUHISA SHIMIZU, PRESIDENT.

WU TELTEX SAC

15:47 EST

MGMCOMP

[Logo] California Teachers Association

GOVERNMENTAL RELATIONS DEPARTMENT

1127 Eleventh Street, Suite 450,
Sacramento, California 95814
(916) 442-5895

August 23, 1985

The Honorable William Baker
Member, Assembly Ways & Means Committee
State Capitol, Room 3013
Sacramento, CA 95814

Dear Assemblymember Baker:

The California Teachers Association is ***opposed*** to SB 85 (Alquist). The repeal or limitation of the unitary method will cause a substantial and continuing loss of state revenues. And, we believe any significant reduction in state revenues will reduce funding available for the public school system of this state.

We respectfully urge your *"NO"* vote when SB 85 is heard by the Ways and Means Committee.

If you have any questions or concerns regarding our position on this measure, please contact CTA Legislative Advocate Rachel A. Joseph at (916) 442-5895.

Sincerely,

/s/ Alice A. Huffman
Alice A. Huffman
Director of Political Affairs

AAH/RAJ/dh

[Logo]
California Chamber of Commerce

1027 10th Street, 4th Floor
• P.O. Box 1736 • Sacramento, CA 95808 •
(916) 444-6670

August 23, 1985

The Honorable William Baker
California State Assembly
State Capitol
Sacramento, CA 95814

Dear Mr. Baker:

Subject: ***SB 85 (Alquist) Unitary Tax Reform***

The California Chamber of Commerce has reviewed ***SB 85 (Alquist)*** *and* ***opposes*** *the bill in its current form. The Chamber believes reform of the unitary tax is essential to continued job growth and economic development in California. SB 85 shows a recognition of the need for change by allowing companies the ability to file tax returns under a water's-edge combination rather than the worldwide method of combination. However, the California Chamber does not feel SB 85 achieves sufficient reform. The Chamber's position is based on the following reasons:*

1. ***Foreign source income of American companies is still subject to tax.*** *Worldwide unitary combination is inappropriate tax policy because it taxes foreign income. SB 85 allows companies to elect water's-edge combination, but taxes foreign dividends which are returned to the United States. For American companies, this means they are still subject to tax on that foreign income. The American companies must not only pay tax on the foreign source income, but by electing water's-edge*

treatment they do not have the benefit of the factor relief that the foreign operations provide.

2. ***SB 85 puts American business at a competitive disadvantage.*** *Because SB 85 taxes the foreign source income of American multinationals, but not foreign multinationals, American companies [are] at a competitive disadvantage. California's business community operates on a worldwide scale. They are able to compete with anyone in manufacturing and sales if they are given an equal playing field. But, American business cannot compete with a tax policy that gives their foreign competition a built-in advantage.*

3. ***Unitary reform should not increase other taxes or fees.*** *SB 85 requires companies electing a water's-edge combination to pay an offsetting tax. The "levy" is clearly a tax because it goes to fund general governmental services, there is no relationship between the amount of the levy and the benefit received by the payor, it is levied on the same basis as the current unitary tax, and it goes on indefinitely.*

The economic growth resulting from unitary reform will mean more property and sales tax revenue to local governments, and income taxes to the state from new employees.

The California Chamber of Commerce has a broad policy on the reform of the unitary tax, which I have enclosed. The Chamber is open to discussion of that policy and any possible agreement. We have indicated this position to Senator Alquist. We hope that he would amend his bill in line with that policy, or in the alternative back to the version of the bill as amended January 24.

In its current form, the California Chamber of Commerce urges a NO vote on SB 85.

Sincerely,

/s/ Fred L. Main
Fred L. Main
Manager/Tax Counsel
Taxation Group

FLM:jrr
Enclosure

ORGANIZATION FOR FAIR TAXATION
OF INTERNATIONAL INVESTMENTS
100 MANHATTANVILLE ROAD
PURCHASE, NEW YORK 10577

NEIL H. GREEN
CHAIRMAN
(914) 251-3961

January 15, 1988

California Franchise Tax Board
Legal Department
Attention: Ms. Susan Borgman
P.O. Box 1468
Sacramento, California 95807-1468

Comments on Proposed Reglations [sic] *25110, 25111, 25112, 25114, and 25120*

Dear Ms. Borgman:

The attached comments are made pursuant to the published invitation of the Franchise Tax Board.

OFTII is a Delaware non-profit corporation, whose members are U.S. subsidiaries of foreign corporations. OFTII

was organized to represent its members' interests in matters relating to Federal and State taxation. OFTII members have very substantial investments in the United States, including significant investments in the State of California. A list of OFTII members showing the nationality of each member's foreign parent is attached.

I trust that our comments will be useful to you. Should you have any questions, please call me at the number above. If you would like to have a detailed discussion of these comments, we would be pleased to organize a visit to Sacramento by one or more of our members.

Yours sincerely,

/s/ N. H. Green
N. H. Green

NHG/ys
Attachments

OFTII MEMBERS

AKZO America, Inc.	Holland
Alcan Aluminum Corporation	Canada
Allied Lyons North Anmerica [sic]	United Kingdom
Barclays Bank	United Kingdom
Batus, Inc.	United Kingdom
British Petroleum of North America	United Kingdom

BASF American Corporation	Germany
Beecham, Inc.	United Kingdom
Elf Aquitaine, Inc.	France
Foseco Minsep	United Kingdom
Gold Fields American Corp.	United Kingdom
GKN North America, Inc.	United Kingdom
American Hoechst Corporation	Germany
ICI Americas, Inc.	United Kingdom
Moet et Chandon	France
Nestle Holdings, Inc.	Switzerland
Shell Oil Company	UK/Holland
Siemens Capital Corporation	Germany
Sony Corporation of America	Japan
Volkswagen of America	Germany
Volvo of America	Sweden
Unilever United States	UK/Holland
Thorn EMI (USA), Inc.	United Kingdom

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31 October 1988

[Logo]

ORGANIZATION FOR
FAIR TREATMENT OF
INTERNATIONAL
INVESTMENT INC.

Wilmington, DE 19897
Tel. (302) 575-3738
Fax. (302) 575-2952

California Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95807-1468

Comments on proposed Regulations 24344(c), 24411, 25110, 25111, 25112, 25114, 25115, and 25401d.

These comments are offered pursuant to the published invitation of the Board.

OFTII is a nonprofit corporation all of the members of which are domestic taxpayer corporations owned or controlled, directly or indirectly, by nondomestic shareholders or corporations. OFTII members have very substantial investments in the United States, including the State of California. There is annexed a list of OFTII members on whose behalf these comments are submitted.

The Board are to be commended for proposing revised regulations that consist with the amended version of SB 85 so soon after that Act's adoption. The second annexure contains some observations of technical problems in a few paragraphs of the revised proposals. These observations do not denigrate the fact that, on the whole, the Board have done a very good job of interpreting SB 85 in a reasonable manner. The principal difficulty noted by OFTII is not the text the regulations proposed, but the

subjects that they *do not cover*: namely, the fundamental problems of who is subject to worldwide combined income reporting and apportionment and, hence, who is properly constrained to make the water's edge election provided in Reg. 25110. This issue is much broader than Reg. 25110, itself. The attempt to resolve these issues by simply referring to cases decided by the United States Supreme Court, the California courts, and the State Board of Equalization (see Reg. 25110, subdivision (d)) provides no real guidance for taxpayers or Board auditors and will simply produce more litigation as these issues are contested on a case by case basis.

The attempt to define a "unitary business" in eleven lines in Reg. 25110(b)(4) does nothing to clear up the enormous confusion that has been the source of years of litigation concerning who is and who is not subject to UDITPA apportionment. In July 1987, the Franchise Tax Board circulated a discussion draft of proposed regulations entitled "Determination of Separate or Unitary Business," numbered 25120(b). These regulations were never listed for hearing and, so far as taxpayers are aware, never progressed past the discussion stage. While there were a number of specific problems with those proposed regulations, they endeavored to fill a pressing need: The establishment of guidelines for the determination of such important basics as who is a "taxpayer" and what is a "unitary group." The State Board of Equalization recently noted the ambiguity that exists in existing regulations concerning the meaning of "taxpayer." In *Appeal of Finnigan Corp.* 88-SBE-022, pp. 161-162 (1988) the Board stated with reference to Reg. 25121(d), that "the word 'taxpayer' is used in, at least, two senses; one in which

the taxpayer is taxable in California, and another in which the 'taxpayer' is not taxable in the state." The United States Court of Appeals for the Seventh Circuit has recently upheld the right of foreign companies whose income was apportioned to California to maintain actions *in federal court* to challenge that apportionment because California refused to grant these foreign companies access to California Courts. *Alcan Alum. v. Franchise Tax Bd.* No. 87-2239, 19 October 1988. The need for clear and workable definitions must be met to avoid even greater confusion and more litigation in the future.

There is a particular need for definitions of "centralized management," "functional integration," "taxpayer," "taxpayer group," and "trade or business," just to name some of the more obvious. Most of the taxpayer disputes with the FTB that have arisen over the last few years have grown out of claims of arbitrary determinations of FTB auditors in deciding who is subject to apportionment, and what types of income are to be included. E.g., Alcan Aluminium Ltd., Shell Oil Corp., EMI Ltd., Imperial Chemical Industries, Barclay's Bank, and Container Corp., just to name some taxpayers who have gone to court or are still in court to press their claims that income was unfairly or improperly apportioned. These issues will not go away until some clear guidelines are established for the benefit of taxpayers and FTB auditors alike. The place to start is with the definitional regulations.

OFTII will be pleased to discuss in detail any matters relating to regulations with Board members or with staff, if such discussion would prove helpful. Please call the

undersigned if it is believed that OFTII can be of assistance.

/s/ Illegible Signature
J.M. Carter
Secretary

Annexures (2)

Directors: Harry Corless, Chairman • Ned W. Bandler • Robert E. Dillon • Donald J. Kapraly • Leonard D. Levin • Alex Spitzer

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UNITARY TAX CAMPAIGN

Unitary Tax Campaign Limited
19 Catherine Place, London SW1E 6DX
Tel: 01-630 5651
Facsimile: 01-821 1490 Telex: 296438 IGAUK G

CAMPAIGN CO-ORDINATING COMMITTEE:
BAT Industries plc., Barclays Bank plc.,
Foseco Minsep plc., Glaxo Holdings plc.,
Hawley Group plc., Imperial Chemical Industries plc.,
National Westminster Bank plc.,
CAMPAIGN ADVISERS:
Ian Greer Associates Limited

January 26, 1988

BY FEDERAL EXPRESS

California Franchise Tax Board
Legal Division
Post Office Box 1468
Sacramento, California 95807-1468
U.S.A.

Attn: Susan Borgman

RE: Unitary Tax Administrative Regulations

Dear Ms. Borgman:

The Unitary Tax Campaign (UTC) and the Confederation of British Industry (CBI) which represent British international companies that have investments in the United States, are pleased to have the opportunity to comment on the proposed administrative regulations.

We have, as you are well aware, consistently opposed the use of worldwide unitary taxation and continue to do so. We welcome in the legislation recognition of the problems created for British business by the use of worldwide unitary tax, but have a number of very serious reservations about it which we have set forth over the years in various communications to interested parties, including the Franchise Tax Board. These include the election fee, the lengthy election period, the continued ability of the Franchise Tax Board to throw taxpayers back onto worldwide combined reporting and the continued compliance burdens. We believe that the combination of these measures will lead to almost all companies not electing. Unfortunately, the legislation and now the regulations, create more uncertainty than ever before. Seeing the two in combination makes us realize that we have a substantial way to go in resolving the difficulties of the unitary problem.

Nevertheless, we are enclosing detailed comments on the draft regulations. We have substantial difficulties with segments of the legislation itself, but we have for the most part confined our comments to the regulations. We strongly believe that the regulations go far beyond the letter and spirit of the legislation passed in September, 1986.

We would be very happy to discuss with you any of the points we have made if you feel that such a meeting would be beneficial. Finally, we hope that the commitment to limiting the use of worldwide unitary tax can be translated into satisfactory and effective legislation and regulations.

Yours sincerely,

/s/ Peter J. Welch/j
Peter J. Welch,
Chairman,
Unitary Tax Campaign

/s/ Keith McDowall/j
Keith McDowall
Deputy Director-General
Confederation of British
Industry

UNITARY TAX CAMPAIGN

Unitary Tax Campaign Limited
19 Catherine Place, London SW1E 6DX Tel: 01-630 5651
Facsimile: 01-821 1490 Telex: 296438 IGAUK G

CAMPAIGN CO-ORDINATING COMMITTEE:
BAT Industries plc., Barclays Bank plc.,
Foseco Minsep plc., Glaxo Holdings plc.,
Hawley Group plc., Imperial Chemical Industries plc.,
National Westminster Bank plc.,
CAMPAIGN ADVISERS:
Ian Greer Associates Limited

28th June, 1988.

Ms. Susan Borgman,
California Franchise Tax Board,
Legal Division,
Post Office Box 1468,
Sacramento,
California 95807-1468
United States of America.

Dear Ms. Borgman,

UNITARY TAX ADMINISTRATIVE REGULATIONS

We are enclosing detailed comments on the second draft of the regulations.

We are very concerned that only one of our substantive comments, on the earlier draft, has been accepted by the FTB. It is fair to say that it is not one of our major points of principle. The UTC and CBI continue to see the regulations as going beyond the spirit and letter of the original legislation, which both the UTC and CBI did not feel able to support.

British business does not think that where we are will solve the problem. A combination of the election fee, the election period, the absence of refund provisions, the 'throw back' provisions and the tone of the second draft of the regulations (and the implications for compliance) are seen by British business as reason for not electing for 'water's edge'. In fact, no member of the UTC currently expects to elect and we understand that, at a meeting earlier this year in the US, only three companies out of about two hundred indicated an expectation of electing. It was interesting that the US Treasury and representatives of the Governor's office in Washington and London, confirmed our analysis that the problem has not been solved.

We would be happy to discuss with you any of the points we have made.

Yours sincerely,

/s/ Andrew Smith
pp
PETER J. WELCH
Chairman
Unitary Tax Campaign

/s/ Andrew Smith
pp
KEN EDWARDS
Deputy Director-General
Confederation of British Industry

UNITARY TAX CAMPAIGN

Unitary Tax Campaign Limited
19 Catherine Place, London SW1E 6DX Tel: 01-630 5651
Facsimile: 01-821 1490 Telex: 296438 IGAUK G

CAMPAIGN CO-ORDINATING COMMITTEE:
BAT Industries plc., Barclays Bank plc.,
Foseco Minsep plc., Glaxo Holdings plc.,
Hawley Group plc., Imperial Chemical Industries plc.,
National Westminster Bank plc.,
CAMPAIGN ADVISERS:
Ian Greer Associates Limited

1st November, 1988.

Ms. Susan Borgman,
Legal Division,
California Franchise Tax Board,
PO Box 1468,
Sacramento,
California 95807-1468
United States of America.

Dear Ms. Borgman,

UNITARY TAX ADMINISTRATIVE REGULATIONS

We are enclosing detailed comments on the amended version of the second draft of the regulations.

We would be happy to discuss with you any of the points we have made.

Yours sincerely,

/s/ Andrew Smith
pp
PETER J. WELCH
Chairman
Unitary Tax Campaign

/s/ Andrew Smith
pp
KEN EDWARDS
Deputy Director-General
Confederation of British Industry

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VICE CHAIRMAN

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DEPUTY DIRECTOR
PATRICK LENZ

CONSULTANTS
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JOHN GRIFFING
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ANDREW SCHAEFER
KEITH UMEMOTO

COMMITTEE SECRETARY
BARBARA BESSON

California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

ROOM 5013, STATE CAPITOL
SACRAMENTO, CALIFORNIA 95814
(916) 445-5202

ALFRED E. ALQUIST
CHAIRMAN

July 14, 1993

Kirk West, President
California Chamber of Commerce
12th Floor, 1201 K St.
Sacramento, CA 95812-1736

Dear Kirk:

In 1986, after several years of intense discussion and negotiation, the California Legislature passed and the Governor approved my SB 85, which provided for a water's edge election. Under this legislation it is now

possible for a multinational group of corporations operating a unitary business to elect to have their California income share determined on a "water's edge" basis rather than under the traditional "worldwide combination" method. The election is accomplished by entering into a contract with the State for a minimum term of five years. The contract requires the taxpayer to comply with certain documentation requirements, to include certain income within the water's edge base, and to pay a relatively modest "election fee" (equal to 0.03% of the sum of it's [sic] California payroll, property and sales factors).

Although there has been scattered grumbling about some of the terms of the water's edge election, generally the business community has been pleased with the results of the SB 85 compromise. However, persistent complaints from some foreign-owned companies and their governments have prompted me to consider a serious review of California's treatment of multinational businesses.

As a beginning step toward that end, Senators Roberti and Maddy have joined me in amending SB 671 to require that our current water's edge method no longer be elective, but be mandatory on all worldwide groups of corporations doing business in California. This approach has not been greeted warmly by the domestic multinationals and it does not necessarily conform with what my colleagues in the Senate and I believe to be the appropriate reform. Therefore, SB 671 was amended in the interest of discussing the issues surrounding unitary taxation in the mid-1990's, and to serve as the vehicle for potential modifications should these prove necessary.

I have attached a chart outlining a range of alternatives to the current water's edge approach, which may serve to frame the broader aspects of the issue for our hearing in the Senate Revenue and Taxation Committee on August 18.

One factor which I should emphasize above all else is that any reform to our present unitary method must not serve as an opportunity to derive additional tax concessions from the State of California which would further erode the state's precarious fiscal position.

Please let me know your views on potential reforms to the water's edge method, so that we may all understand where everyone stands on the issue.

Sincerely,

/s/ Alfred E. Alquist
ALFRED E. ALQUIST

cc: Other Interested Parties

Unitary Options

1. Do nothing (leave SB 85 water's edge approach in place)	This "null" approach would be unlikely to placate the British and it would not lend support to a U.S. administration position that "California is doing it's part to resolve this difficulty." However, in face of some alternatives, a large number of domestic-based corporations would prefer this option.	Revenue neutral
2. Adopt "mandatory water's edge" approach (SB671 – Alquist)	Apparently requested by both U.S. Treasury AND British representatives, this approach would disadvantage a large number of mainly domestic-based corporations who prefer (for reasons of tax minimization) to remain under world-wide combination.	Revenue gain of $100 plus million, which could be balanced by a reduction in the franchise tax rate from 9.3% to 9.1%
3. Revert to pre-SB 85 system (mandatory worldwide combination)	SB 85 (Alquist – 1986) was a heroic attempt to resolve domestic and international concerns over our worldwide method. If British retaliation is a sign that the attempt was an utter failure, then perhaps it should be abandoned.	Revenue gain of $300 plus million (which could be balanced by a rate reduction do 8.7%)
4. Take a step beyond SB 85 by providing a permanent election to use water's edge OR worldwide combination, with no election fee.	If the SB 85 election-with-fee structure was considered a temporary stopgap and an attempt to extract a *quid pro quo* from those electing water's edge, then perhaps the time has come to consider "normalizing" the system by treating water's edge on a par with worldwide combination. (This option would also involve removing FTB's ability to disregard the election, and perhaps the domestic disclosure spreadsheet (DDS).)	Revenue loss of $100 million (about half of which would be loss of the election fee). Could be balanced by an increase in tax rate to 9.5%.
5. Adopt AB 2084 (Takasugi), which repeals the DDS and the FTB disregard power.	A minimalist response, which could serve to test the proposition that the point which angers the British the most is FTB's power to unilaterally disregard the election.	Relatively minor and speculative revenue loss if a monetary penalty is substituted for FTB's disregard power.
6. Adopt a hybrid system, which would (1) continue the election fee for those who wish the option of reverting to worldwide at some time, and (2) provide a permanent election (as in 4. above) for those who wish to avoid the election fee.	This option would contain the features of 4., above, and would test the notion that unitary corporate groups would desire the option of electing OUT of water's edge should events turn out differently than planned.	Revenue loss of less than $100 million, to the extent that some groups would continue to use the temporary election, and pay the fee. A tax rate of between 9.3% and 9.5% might balance the package.

Note that all revenue estimates mentioned above are speculative, and would need to be confirmed by FTB and Finance.

Senate Rev & Tax mh July 13, 1993

APPENDIX C

CBI

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
Maurice Hunt
Deputy Director-General

17 August 1993

The Hon David A Roberti
President pro Tempore
California State Senate
State Capitol
Room 205
Sacramento
California
95814
USA

Our ref 08/07

Dear Senator Roberti,

Unitary Taxation

I am writing to you in connection with the discussions on unitary taxation about to take place in the Californian [sic] Legislature.

Unitary taxation on a worldwide combined reporting basis is a matter which is of vital importance and increasing concern to British business. Our concern has been reflected in the action we have taken over the years both in California and elsewhere in the United States by way of submission of written and oral evidence in relevant legislative and judicial proceedings with a view to securing its curtailment.

To assist in the current deliberations I am enclosing some material which explains more fully the problems which California's unitary tax system creates for British companies wishing to establish themselves in or do business with California.

If you would like further copies we shall be pleased to provide them. I hope that you will find this material helpful as a guide to how we in British business see the situation overall.

If there is any further assistance we can provide please do not hesitate to let me know.

Yours sincerely,

/s/ Maurice Hunt
Maurice Hunt

Enc.

CBI

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 071-379 7400
Facsimile 071-240 1578
Telex 21332

From
Maurice Hunt
Deputy Director-
General

27 August 1993

Mr Fred Silva
Chief Consultant
Fiscal Unit
State Capitol, Room 400
Sacramento
California 95814
USA

Our Ref. 08/07

Dear Mr. Silva,

Californian Unitary Tax: SB671 (amended 23/8/93)

In our position paper on Californian unitary tax which we sent you earlier this month we explained a number of difficulties which British business had identified with the existing Californian unitary tax legislation in the hope that our explanation would be of assistance to you in the current review of this tax, in particular the debates on SB671.

Following the amendments made to SB671 up to 23 August 1993 we are pleased to note that a number of our concerns have been acknowledged by the Californian

authorities as warranting changes to the unitary tax regime.

At the same time however there remain a number of serious concerns which still need to be addressed. We offer some further thoughts on these based on the amended text of SB671.

Again we put these forward in a constructive spirit with a view to assisting in the crafting of legislation to meet the fundamental difficulties which we identified in our previous paper. Our central objective in this is to ensure that taxpayers have an unconditional entitlement to water's edge treatment.

Yours sincerely,

/s/ Illegible Signature
pp
Maurice Hunt

Enc.

NATIONAL FOREIGN TRADE COUNCIL, INC.
1625 K STREET, N.W., WASHINGTON, DC 20006
Tel: (202) 887-0278 [LOGO] FAX: (202) 452-8160
NEW YORK OFFICE:
1270 AVENUE OF THE AMERICAS,
NEW YORK, NY 10020-1700
• TEL: (212) 399-7128 • FAX: (212) 399-7144

August 12, 1993

The Honorable David Roberti
California State Senate
Capitol Building
Room 205
Sacramento, CA 95814

Dear Senator Roberti:

The National Foreign Trade Council, Inc. (NFTC) appreciates the opportunity to comment on prospective legislation (S.B. 671) being considered by the California legislature to revise the method by which foreign and domestic multinational companies are taxed on their business operations in California.

The NFTC is a trade association with some 500 members, founded in 1914. Its membership consists primarily of U.S. corporations engaged in all aspects of international business, trade, and investment. The NFTC's objective is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax and trade inequities in the treatment of U.S. companies conducting business abroad.

On behalf of its member companies, the NFTC has been quite active in efforts to pursue a legislative solution in California that satisfies both the revenue concerns of

the State of California and avoids retaliation by the UK and other foreign governments against U.S. business interests operating in their countries. Many member companies of the NFTC have a substantial presence in California and also in the UK and in other foreign countries.

As you are aware, the UK has threatened to retaliate by denying the refund (ACT) available to U.S. companies under the existing UK-U.S. Income Tax Treaty unless California adopts legislation by the end of this year to repeal the mandated use of the worldwide unitary Method for UK companies conducting business in California. Similar complaints have been lodged against the unitary method by other EC countries, including Germany and the Netherlands.

The overriding objective of the NFTC is to press for enactment of legislation in California prior to the date of adjournment this year which meets California's revenue requirements and satisfies the concerns of the UK to avoid retaliation against U.S. business interests. (Emphasis supplied)

The NFTC offers the following comments and suggests modifications to S.B. 671 in order to satisfy the concerns of the UK and other foreign governments and also to provide a fair taxing regime in California for both U.S. and foreign multinational companies.

1. *Waiver of election Fee.* The fee imposed under present law to elect the water's edge method for filing should be repealed. We believe that inclusion of this recommendation in legislation is essential to avoid UK retaliation.

2. *The election of a water's edge method should be irrevocable.* The ability of multinational companies, both foreign and domestic, to elect use of the water's edge method for filing must be irrevocable. If the authority of the Franchise Tax Board officials to revoke the water's edge election under present law is retained, it is quite certain that the UK will retaliate against U.S. interests.

3. *The domestic spreadsheet should not be required.* The domestic spreadsheet requirement should be deleted. The compliance costs to companies of providing this information vastly exceeds any audit advantage to California taxing authorities. The NFTC and its membership can support the alternative suggestion of the Franchise Tax Board that a list of 20 percent or more owned affiliated corporations could be provided by companies with a minimum of one billion dollars in assets.

While the NFTC has other modifications that it could suggest to improve the tax system for multinational companies, both foreign and domestic, in California, the compelling need for enactment of legislation by the date of adjournment to avoid UK retaliation dictates that other recommended changes must be deferred for consideration until a later date. Adoption of legislation by California that includes the items recommended above should satisfy UK concerns and avoid a destructive tax war between the U.S. and its major trading partners that would undermine the investment climate in both countries.

The NFTC commends you and your colleagues in the California legislature for your efforts to seek a solution to this troublesome problem. The NFTC recognizes that any

solution must carefully balance the interests of the State of California and its need for revenue neutrality against the potential losses to be suffered by U.S. businesses operating abroad if countries, such as the UK, act upon their threatened retaliation at the end of this year.

We would be pleased to respond to any questions that you may have.

Very truly yours,

/s/ Frank D. Kittredge
Frank D. Kittredge
President

SENATE THIRD READING

SB 671 (Alquist) – As Amended: September 9, 1993

SENATE VOTE: 26-8

ASSEMBLY ACTIONS:

COMMITTEE REV. &. TAX VOTE 6-0

COMMITTEE W. & M. VOTE 14-7

Ayes: Horcher, Allen, Costa, Epple, Johnson, Brulte, Lee, Murray, Nolan, O'Connell, Polanco, Quackenbush, Seastrand, Woodruff

Nays: Vasconcellos, Alpert, V. Brown, Burton, Campbell, B. Friedman, Hannigan

DIGEST

Existing law provides for the apportionment of income for firms doing business both within California and outside the state, for deductions against income of certain meals and entertainment expenses, a credit for certain research and development activities, a sales and use tax on the purchase of manufacturing equipment, and various other provisions.

Existing law, income apportionment, provides that for corporations which operate both within California and in other states or nations, the portion of the firm's total income attributable to California is determined by a "three-factor" formula relating the company's payroll, property and sales in California to the total of those factors nationwide or worldwide.

However, a company can make a "water's-edge" election. Under this method, a firm can compute its California

taxable income by reference to its income and apportionment factors from within the "water's-edge" only, rather than worldwide. Essentially, this means foreign business operations are excluded from the calculation.

There are various requirements for companies making the water's-edge election, and the Franchise Tax Board (FTB) has certain authority to enforce these provisions. Specifically, the water's-edge legislation required a firm making the election to: 1) pay an election fee; 2) file a "domestic disclosure spreadsheet" every three years if the firm had property, payroll or sales which exceeded specified amounts; and 3) allow FTB to "disregard" a company's water's-edge election of the FTB determined that the taxpayer willfully refused to provide specified audit information.

This bill:

1) *Income Apportionment.* Makes various changes to California's unitary method of income apportionment, including:

   a) Deletes the requirement to file the domestic disclosure spreadsheet for firms making the water's-edge election, and replaces this requirement with a minimal reporting requirement for firms with over $200 million in assets.

   b) Eliminates FTB's authority to "disregard" a water's-edge election. In place of the disregard authority, the bill requires taxpayers to provide specified audit information. Taxpayers failing to provide that information would be subject to a substantial penalty (in lieu of the current disregard power).

   c) Repeals the election fee for taxpayers filing their return on a water's-edge basis. The repeal is effective for income years beginning on or after January 1, 1994.

2) *Business Meals.* Reduces from 80% to 50% the percentage of business meals and entertainment which may be deducted as an ordinary and necessary expense. This change is consistent with recent federal tax law changes.

3) *Subchapter S.* Reduces from 2.5% to 1.5% the tax rate applied to Subchapter S corporations.

4) *Investment Tax Credit.* Establishes a tax credit equal to 6% of qualified manufacturing equipment placed in service after January 1, 1994. However, the credit could not be claimed prior to a taxpayer's 1995 tax year.

   The credit could only be claimed for manufacturing equipment which is "depreciable" under certain federal tax rules. Additionally, "special purpose buildings and foundations" for certain electronic manufacturers would be eligible for the credit, as would property related to specified biotech engineering activity.

   The credit could be claimed against both the regular tax and the alternative minimum tax, and unused credits could be carried forward for up to 8 years (10 years for "small" firms).

   The credit would sunset January 1, 2001 if manufacturing employment in California (except aerospace employment) does not increase by at least 100,000 between January 1, 1994 and January 1, 2001.

   Additionally, the measure allows a "start-up" firm the option of a 5% sales tax exemption on qualifying manufacturing equipment during its first 3 years of

operation (e.g., a start-up firm could take either the 6% income tax credit or the 5% sales tax exemption). A start-up firm is defined as a firm which begins business after January 1, 1994.

5) *Space Flight Material.* Exempts from the sales and use tax space flight material used in a launch originating at Vandenberg Air Force Base. This exemption sunsets January 1, 2004.

6) *Research and Development Credit.* Deletes the January 1, 1998 sunset date of the research and development tax credit, thereby making the credit permanent. Additionally, the measure replaces the state's "three-year rolling average" method of calculating the credit with the federal "fixed base" method.

7) *Small Business Stock Capital Gains.* Exempts from taxation 50% of the capital gain realized from the sale of a qualified small business stock held for 5 or more years. For a stock to be eligible for this income exclusion, it must meet the following criteria:

   a) Must be originally issued after August 10, 1993 and before December 31, 1998, by a company doing business in California which has less than $50 million in gross assets. At least 80% of the qualifying company's payroll must be attributable to employment located in California.

   b) The issuing company cannot be engaged primarily in the performance of specified services including: health, law, engineering, accounting, performing arts, or consulting. Additionally, firms engaged in banking, insurance, farming, oil and gas extraction, or hotels and restaurants cannot issue qualifying stock.

These criteria are consistent with recent federal tax changes which create a similar capital gains exemption.

FISCAL EFFECT

State: The net effect of estimates provided by FTB, the Board of Equalization and the Governor's office is that this measure would generate revenue losses of approximately $27 million in 1993-94, $92 to $142 million in 1994-95, $368 to $418 million in 1995-96, and $375 to $425 million in 1996-97. The effect of the individual provisions of the bill are summarized in Attachment I.

Local: Annual revenue losses in the range of $1 million due to the bill's exemption for space flight material.

Attachment I

SB 671 (Alquist) Summary of Fiscal Effect
($ in millions)

	1993-94	1994-95	1995-96	1996-97
Repeal Water's-Edge Election Fee	$-15	$-60	$-75	$-80
Research & Development Tax Credit	-22	-45	-50	-60*
Small Business Stock Capital Gains Exemption	---	---	---	---**
6% Investment Tax Credit	---	-50 to -100	-300 to -350	-300 to -350
Reduce Business Meals Deduction	+40	+140	+150	+160
Sales Tax Exemption for Space Flight Property	---	-7	-15	-15
Reduce Subchapter S Tax Rate	-30	-70	-78	-80
Net Fiscal Effect	-27	-92 to -142	-368 to -418	-375 to -425

* Deletion of sunset will increase this loss beginning in 1998-99 by about $150 million and by increasing amounts annually thereafter.

** Revenue losses from capital gains exclusion do not begin until 1998-99 and are in the range of $15 million, increasing to $43 million by 2001-02.

Source: Franchise Tax Board, Board of Equalization, Governor's Office

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether California's worldwide combined reporting method of determining the portion of the income of a unitary business attributable to its activities in California is constitutional under the foreign Commerce Clause and the Due Process Clause as applied to either a unitary group with a foreign parent (Barclays) or a unitary group with a domestic parent (Colgate-Palmolive).

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BRIEF OF THE COUNCIL OF STATE GOVERNMENTS, NATIONAL GOVERNORS' ASSOCIATION, U.S. CONFERENCE OF MAYORS, INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL ASSOCIATION OF COUNTIES, AND NATIONAL CONFERENCE OF STATE LEGISLATURES AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICI CURIAE*

Amici, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments. Among the most important of such issues are those raised by federal limitations on state and local taxing authority. The petitions in these two cases raise constitutional challenges under the foreign Commerce Clause and the Due Process Clause to California's worldwide combined reporting method of taxation. With more than $2 billion in tax revenues at stake in California alone (Colg. Supp. Br. on Petition 4, Resp. Op. Cert. Colg. 15), this case presents a grave challenge to the existing tax schemes, revenue-raising powers, fiscal health and legislative discretion of state governments. *Amici* have a vital interest in seeing that this threat is turned back and the decisions below affirmed.[1]

STATEMENT

These cases involve the application of two methods of determining the portion of the income of a unitary multinational business attributable to its activities in a taxing jurisdiction. The two methods are worldwide combined reporting (WWCR), which is a type of formulary

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[1] The parties' letters of consent to the filing of this brief have been filed with the Clerk pursuant to Rule 37.3 of the Rules of this Court.

apportionment, and arm's length/separate accounting (AL/SA).

Under WWCR, as applied by California in the income years in question (1970-1973 and 1977), once a multinational business has been determined to be unitary (*i.e.*, operating as a single economic enterprise, even though divided into many subsidiaries or branches), the multinational is treated as one unit and the portion of its income attributable to California is determined based on a formula that takes into account the taxpayer's capital (property), labor (payroll), and the use of the market (sales) in California compared to the same factors on a worldwide basis. Pet. Br. Colg. 5-6.

Under AL/SA, instead of treating the unitary group as a single business, each separate subsidiary or branch of the multinational group is treated as if it were an independent enterprise dealing with all other units of the multinational group on an arm's length basis. *Id.* at 4-5.

Both petitioners have conceded that their operations in California (directly by the parent in the case of Colgate, and through a separate subsidiary (Barcal) and a branch of a U.K. corporation (BBI) in the case of Barclays) were part of single unitary businesses which included all other corporations in their controlled groups (approximately 220 corporations in the case of Barclays, and approximately 75 corporations in the case of Colgate). *Id.* at 4; Pet. Br. Barc. 3.

Barclays filed its income tax returns in California, with Barcal filing a separate accounting return and BBI filing a worldwide combined return for itself and all of its U.S. and foreign subsidiaries, including Barcal. Pet. Br. Barc. 11-12. Colgate filed its California return for the parent only, excluding its foreign subsidiaries. Pet. Br. Colg. 10. On audit, the California Franchise Tax Board determined (as petitioners here concede) that both petitioners constitute unitary businesses and therefore should file combined returns for their entire worldwide unitary groups. *Id.*; Pet. Br. Barc. 11. This change in method

of filing resulted in more of petitioners' income being attributed to California. Pet. Br. Colg. 10; Pet. Br. Barc. 11-12.

Petitioners now challenge the resulting increase in their tax burden on constitutional grounds, arguing that WWCR violates the foreign Commerce Clause and (in the case of Barclays) the Due Process Clause. Thus, petitioners argue that the Constitution mandates that California use AL/SA in taxing either a multinational unitary group with a foreign parent (Barclays) or a multinational unitary group with a U.S. parent (Colgate).

INTRODUCTION AND SUMMARY OF ARGUMENT

Petitioners' arguments depend on their portrayal of WWCR as a radical method used by California that is the antithesis of the arm's length method used by the federal government and the rest of the world. Pet. Br. Barc. 16; Pet. Br. Colg. 4-6. In reality, however, arm's length and WWCR approaches are not incompatible opposites, as petitioners would have this Court believe, but are part of a continuum. At a recent conference, both proponents and opponents of WWCR from the international community agreed that

> the arm's length principle and formulary apportionment should not be seen as polar extremes; rather, they should be viewed as part of a continuum of methods ranging from [comparable uncontrolled prices] to predetermined formulas. It is not clear where the arm's length principle ceases and formulary apportionment begins, and it is counterproductive and unimportant to attempt to apply labels to the methods.

Brian J. Arnold and Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation Of Income And Expenses Among Countries*, 61 Tax Notes 1377, 1381 (December 13, 1993).

Formulary methods similar to WWCR are commonly used in conjunction with the arm's length method by the

federal government and other countries. In recent decades, the federal income tax rules relating to the allocation of income in the international context have been evolving under the pressure of economic reality away from a pure arm's length approach based on comparable transactions, to a combination of comparable transactions and formulary approaches in the absence of comparables. *See e.g.*, 26 U.S.C. § 863(b); 26 C.F.R. § 1.863-3T(b). In this context, the United States is leading the world toward a new consensus that arm's length and formulary approaches are both parts of an acceptable continuum of methods.

The federal government's resort to formulary methods in conjunction with arm's length arises out of a central flaw in the arm's length approach which precludes its use in "pure" form. Indeed, Professor Langbein has commented that, because of these flaws, "arm's length, defined as the antithesis of fractional apportionment, not only is not a norm, it is not even meaningfully a concept." Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 655 (February 17, 1986).

The arm's length method seeks to allocate the profits of each member (or branch) of a unitary group "as if those profits were earned by a separate enterprise." Barc. Petition 5. The obvious problem with this approach is that in the absence of actual comparable transactions between unrelated enterprises, it is often impossible to reconstruct what the hypothetical profits of the related enterprises should be. As this Court has recognized, the failure of separate geographic accounting to account for "factors of profitability [which] arise from the operation of the business as a whole" makes it "misleading to characterize the income of the business as having a single identifiable 'source.'" *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 438-39 (1980).

This problem led the federal courts, in a series of cases beginning in the 1970s, to apply a variety of formulary

methods to allocating the profits of the related enterprises. The federal government, which has long used formulary methods in combination with arm's length, formalized its use of this approach in 1993 with the issuance of temporary regulations applying a formulary approach in the absence of comparable arm's length transactions. *See* Intercompany Transfer Pricing Regulations Under Section 482, 58 Fed. Reg. 5310 (1993) (codified at 26 C.F.R. §§ 1.482-0T through 7T) ("temporary regulations").

Once the false dichotomy between WWCR and arm's length (as applied by the federal government) is exposed, petitioners' arguments crumble. It becomes clear that California's taxation method is permissible under this Court's foreign Commerce Clause[2] and Due Process Clause precedents.

1. As enunciated in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), and elaborated in *Container Corporation of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), the foreign Commerce Clause requires that a state tax scheme implicating international commerce meet two tests: first, it must not prevent the federal government from "'speaking with one voice' in international trade," *Container*, 463 U.S. at 193 (quoting *Japan Line*, 441 U.S. at 453), and, second, it must not result in international multiple taxation that can reasonably be eliminated by the State. *Container*, 463 U.S. at 189-90.

California's formulary method does not violate the "one voice" requirement of the foreign Commerce Clause because it is consistent with the method applied by the federal government itself in apportioning the income and deductions of corporations engaged in international commerce.

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[2] The Franchise Tax Board argues that because Congress has acted to permit it to use WWCR, dormant Commerce Clause analysis is inapplicable to this case. *Amici* agree. However, to avoid duplicating respondent's extensive treatment of this issue, this brief will focus on demonstrating the constitutional validity of California's WWCR methodology, even assuming that dormant Commerce Clause analysis is applicable.

In fact, the federal government applies formulary approaches, in conjunction with the arm's length method, to U.S. branches of foreign corporations (including banks, such as BBI), to foreign corporations controlled by U.S. parents (such as Colgate and its subsidiaries), and to U.S. subsidiaries of foreign parents (such as Barcal); by international consensus, those formulary approaches do not violate the tax treaties entered into by the federal government. *See* Louis M. Kauder, *The Unspecific Federal Tax Policy of Arm's Length: A Comment On The Continuing Vitality of Formulary Apportionment At The Federal Level*, 60 Tax Notes 1147 (Aug. 29, 1993).

Moreover, in the context of allocating profits between a foreign corporation and its U.S. branch, the federal government has used a formulary approach virtually identical to California's since 1922. *See Intel Corp. and Consolidated Subsidiaries v. Comm'r*, 100 T.C. No. 39 (June 28, 1993), *reprinted in* BNA Daily Tax Report, June 29, 1993 at K-5, K-7–K-8, 1993 U.S. Tax Ct. LEXIS 38 (citing 42 Stat. 227, 244-45 (1921); Regs. 62, art. 327 (1922)). These methods are fully compatible with the arm's length approach and have achieved international acceptance. Thus, this Court should not hold that WWCR violates the "one voice" prong of the foreign Commerce Clause, since the federal government itself uses formulary methods akin to WWCR ubiquitously in its international tax regime.

2. In addition, as this Court held in *Container*, WWCR does not violate the multiple taxation prong of the foreign Commerce Clause because it does not pose more risk of multiple taxation than the arm's length method, as applied by the federal government. *See Container*, 463 U.S. at 191. Developments in the federal tax arena since 1983, when *Container* was decided, have dramatically demonstrated that "California would have trouble avoiding double taxation even if it adopted the 'arm's length' approach" as it is applied by the United States and interpreted by the courts under 26 U.S.C. § 482. *Container*, 463 U.S. at 192. In fact, the International Chamber of Commerce, in commenting on the recently issued temporary regulations implementing the federal approach to this issue under 26 U.S.C. § 482, has stated that the regulations "will inevitably lead to double taxation." Letter of International Chamber of Commerce of 4/22/93, ¶ 21, *reprinted in International Chamber of Commerce Attacks New Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 113-24 (May 27, 1993).

3. California's WWCR does not violate the Due Process Clause because it is no more burdensome or arbitrary than analogous federal provisions, which have not been challenged on due process grounds. California does not impose a heavier burden on U.S. subsidiaries of foreign parents, such as Barcal, than is already imposed on domestic corporations that are 25 percent or more foreign-owned (under 26 U.S.C. § 6038A and the regulations thereunder) or for U.S. branches of foreign corporations, such as BBI (under 26 U.S.C. § 6038C). Nor are the standards used by California in applying WWCR any more vague or capricious than the standards used by the federal government under the corresponding provision of federal tax law, 26 U.S.C. § 482, which was first enacted in substantially its present form in 1928. Hence, WWCR cannot be invalidated on due process grounds without casting a heavy shadow over analogous, generally accepted provisions of federal tax law.

ARGUMENT

I. CALIFORNIA'S FORMULARY METHOD DOES NOT VIOLATE THE FOREIGN COMMERCE CLAUSE

Petitioners' contention that California's use of WWCR violates the foreign Commerce Clause is premised on two core arguments: first, that WWCR prevents the federal government from " 'speaking with one voice' in international trade," and, second, that it results in international multiple taxation that can reasonably be eliminated by the use of arm's length. Each of these arguments is meritless.

Petitioners' one voice argument depends on their depiction of WWCR as an idiosyncratic tax system that is "separate and different" from, and "incompatible with," the "international standard" of arm's length. Pet. Br. Barc. 16. This reductionist portrayal is irreconcilable with reality. Formulary apportionment is not idiosyncratic and has been repeatedly upheld by this Court. *See, e.g., Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Mobil Oil*, 445 U.S. at 438-40; *Container*, 463 U.S. at 197. Equally important, formulary apportionment and arm's length are not, as petitioners would have this Court believe, polar opposites, but are part of a continuum. *See, e.g.*, Arnold & McDonnell, *Report on the Invitational Conference*, 61 Tax Notes at 1381. Indeed, as employed by the federal government, arm's length commonly uses formulary components. There is no basis for petitioners' assertion that California prevents the federal government from speaking with one voice, because the federal government uses formulary methods ubiquitously in its international tax regime.

Petitioners' multiple taxation argument is likewise unavailing. WWCR does not violate the multiple taxation prong of the foreign Commerce Clause because it does not pose more risk of multiple taxation than the arm's length method as applied by the federal government.

The errors in petitioners' analysis of these two issues flow from a common source. As *amici* show immediately below, the inherent limitations of the arm's length method as applied to multinational parents and subsidiaries routinely compel taxing authorities, including the United States, to use elements of formulary apportionment in conjunction with tax systems denominated "arm's length."

A. The Basic Theoretical Weaknesses Of The Arm's Length Approach, Recognized By This Court, Require Resort To Formulary Methods

In upholding the constitutional validity of formulary apportionment, the Court has repeatedly emphasized the theoretical failings inherent in the arm's length method.

In *Mobil Oil*, and again in *Container*, the Court explained that

> separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

Mobil Oil, 445 U.S. at 438 (internal citation omitted), *quoted in Container*, 463 U.S. at 181; *see also Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 378 (1991); *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 74 (1989). It is not possible to determine accurately the income of each component of a unitary business on a separate, geographic basis because, as the Court has observed, the underlying profit figures "are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." *Container*, 463 U.S. at 181; *see also* Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment*, 60 Tax Notes 1131, 1140-41 (August 23, 1993).[3]

"[S]licing a shadow," as the *Container* Court called the attempt to allocate the income of a unitary group geographically, 463 U.S. at 192, does not become any easier if the unitary group, as in this case, crosses national as well as state boundaries. A simple example illustrates the problem.

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[3] The Court's reasoning defeats Barclays' argument (Pet. Br Barc. 24) that formulary methods erroneously assume equal profitability of all portions of the unitary enterprise. Formulary methods are necessary precisely because there is no way of establishing accurate profit figures for each component of a unitary enterprise.

Suppose foreign parent (FP) manufactures a widget at a cost of 50 and sells it to domestic subsidiary (DS) which resells it for 100. If DS has marketing costs of 20, it would have a profit if it bought the widget for any price below 80, while FP would have a profit if it sold the widget for any price above 50. The interval, between 50 and 80, represents a potential profit continuum, and the related parties can split it in any way they wish and still each make a profit. In the absence of comparable transactions with unrelated taxpayers, it is virtually impossible to definitively allocate the profit of 30 to either party.

Ordinarily, one could attempt to split the profit based on the economic functions performed by the parties. In the context of a unitary group, however, there is an additional economic reality that complicates this task: Like any organization, unitary groups exist because of market and non-market advantages that are derived from their structure. *See, e.g.*, J. Hellerstein, *Federal Income Taxation of Multinationals*, 60 Tax Notes at 1135-36. Thus, even if one applies a market rate of return separately to each of the components of the unitary group, the result is less than the actual return of the organization as a whole. The synergistic interaction among the constituent parts of the organization results in a residual that cannot be assigned to any separate geographic component.[4]

Any rule that arbitrarily assigns this residual to a member of the group distorts economic reality, because there is no single correct arm's length result. *See* H.R. Rep. 426, 99th Cong., 1st Sess., 423-24 (1985) ("A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept

[4] If there is a large residual resulting from the advantages afforded by the group's unitary structure, that same residual drives competitors out of the market, making comparables even less likely to be found. *See* Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 654-55, 666-69 (February 17, 1986).

in the absence of comparables.") (footnotes omitted); David R. Tillinghast, *An American View of International Intercompany Pricing Problems, in* 1979 Conference Report: Report of the Proceedings of the Thirty-First Tax Conference 469, 476 (Canadian Tax Foundation 1980) (where comparable uncontrolled transactions do not exist, "the plain fact . . . is that there is no such thing as an arm's-length price"), *quoted in* J.A. 827 (trial testimony of Tillinghast as Barclays' expert witness).[5]

In a long series of cases since 1980, this problem has bedevilled the federal courts in their attempts to deal with transfer pricing issues under 26 U.S.C. § 482 in the absence of comparables. The result has been a series of stupendously long, fact-based opinions in which the courts eventually split the residual profit between the related parties based on some vague understanding of their respective functions. Judge Tannenwald recently described the dilemma the Tax Court faces in making allocation decisions in Section 482 cases as a task that is "most difficult to perform in light of the [c]ourt's inevitable lack of knowledge of the realities of the workings of a specific industry and of the business world generally, including particularly the international competitve atmosphere which those realities reflect." *Perkin-Elmer Corp. v. Comm'r*, T.C. Memo 1993-414, 1993 Tax Ct. Memo LEXIS 424 at 97-98 (Sept. 8, 1993). The court must nevertheless find "precise answers based on an imprecise record," *id.* at 98, usually by "find[ing] a middle ground—a task which

[5] *See also* J.A. 829 (expert testimony of Tillinghast) ("the basis on which [the] division of profit is made varies according to the judgment of the auditing agent and the IRS as to what would produce a reasonable approximation of what an arm's-length price would be"); Langbein, *The Unitary Method*, 30 Tax Notes at 654-55; Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 Tax Notes 339, 345-47 (July 20, 1992); U.S. General Accounting Office, GAO/GGD-92-89, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices* 60-62 (June 1992).

it has disavowed, in other contexts." *Id.* (citation omitted). "The task thus thrust upon us is," he wrote, "to put it mildly, frustrating." *Id.* at 96. *See also Hospital Corporation of America v. Comm'r*, 81 T.C. 520, 596-97, 601 (1983) (noting "the lengthy and inconclusive record" but finding "as a fact that 75 percent of the taxable income of LTD in 1973 was attributable to petitioner"); *Eli Lilly & Co. v. Comm'r*, 84 T.C. 996, 1191 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comm'r*, 88 T.C. 252, 376 (1987) ("best judgment" allocation of profit); *Sundstrand Corp. v. Comm'r*, 96 T.C. 226, 375 (1991) ("best estimate" by court of appropriate transfer price).[6]

Alternatively, to avoid such "rough justice" approximations, the federal courts have strained to find comparables where no economic comparables exist. Thus, in *United States Steel Corp. v. Comm'r*, 617 F.2d 942, 951 (2d Cir. 1980), the court of appeals found that a comparable existed despite widely different volume and risks, even though it realized that the result did not reflect "economic reality." A similar outcome was reached in *Bausch & Lomb, Inc. v. Comm'r*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991). The Tax Court held that a comparable was valid despite the extremely different economic conditions existing between the related parties, and the court of appeals affirmed, reasoning that such differences "will always be the case when transactions between commonly-controlled entities are compared to transactions between independent entities." 933 F.2d at 1091.

This burgeoning series of cases, which threatens to overwhelm the IRS and the Tax Court,[7] has led to increasing

[6] In the United States Claims Court (and its predecessor, the Court of Claims), the result has been one-sided victories for either side. *Compare E.I. Du Pont De Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979), *cert. denied*, 445 U.S. 962 (1980), *with Merck & Co., Inc. v. United States*, 24 Cl. Ct. 73 (1991).

[7] "For the foreseeable future, transfer pricing litigation will place a heavy burden on the Service and the Tax Court." U.S. Treasury and IRS, *Report on the Application and Administration of Section 842* at 6-3 (April 9, 1992), *reprinted in* BNA Special Supplement 2, Report No. 70 at S-34 (April 10, 1992) (bound with BNA Daily Tax Report) (hereinafter "Treasury and IRS Report"); *cf.* GAO, *International Taxation* at 47 ("transfer pricing cases in general can be very burdensome, time-consuming, and expensive for the courts, IRS, and the companies involved").

In recent transfer pricing litigation under Section 482, Chevron produced 1.3 million pages of unlabelled documents to the IRS. *See Chevron Not Required to Label 1.3 Million Pages Turned Over To The IRS*, BNA Tax Management, Transfer Pricing Report, at 135-36 (July 7, 1993).

criticism by the General Accounting Office and by Congress of AL SA as applied at the federal level. *See* U.S. General Accounting Office, GGD-81-81, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (Sept. 30, 1981); H.R. Rep. 426, 99th Cong., 1st Sess. 423-25 (1985). The Conference Report on the 1986 Tax Reform Act instructed the IRS to conduct a study of the problem and to consider carefully "whether the existing regulations [implementing AL SA] could be modified in any respect." H.R. Rep. 841, 99th Cong., 2d Sess. II-638 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4726. The result of these criticisms has been, first, a lengthy study by the Treasury Department recommending significant changes to AL SA, Notice 88-123, 1988-2 C.B. 458 (the "White Paper"); second, proposed regulations with additional changes; and finally, in January 1993, the adoption of temporary regulations which significantly modify AL SA at the federal level. 58 Fed. Reg. 5310 (1993) (codified at 26 C.F.R. § 1.482-0T through 7T). The most significant change in these temporary regulations is the express incorporation of formulary approaches into AL SA in the absence of exact comparables. *See id.* at § 1.482-5T. As discussed immediately below, this is only the most recent development in the United States' long-standing use of formulary methods in conjunction with arm's length.

B. California's Method Does Not Violate The "One Voice" Requirement Of The Foreign Commerce Clause Because The Federal Government Uses Formulary Apportionment Itself In Conjunction With The Arm's Length Method

1. *The Federal Government Uses Formulary Apportionment In Conjunction With Arm's Length*

Petitioners' entire "one voice" argument is based on a false dichotomy between the "pure" AL/SA allegedly used by the federal government and other countries, and WWCR. *See, e.g.*, Pet. Br. Barc. 4-5, 16. However, the federal government—like other nations—does not adhere to pure AL/SA; instead, it commonly uses a combination of AL/SA and formulary approaches. Once this is recognized, the key assumption underlying petitioners' "one voice" argument crumbles. For why should California be forced to change its taxing method to comply with a single federal voice, when that voice itself uses methods similar to California's?

As this Court recognized in *Container*, AL/SA as applied by the United States is neither pure nor simple. It is a "qualified" arm's length approach under which every corporation is treated "for most—but decidedly not all—purposes as if it were an independent entity." 463 U.S. at 184-85. And there are "elaborate regulations" implementing the ability of the IRS to " 'distribute, apportion or allocate gross income' " among related taxpayers under 26 U.S.C. § 482. 463 U.S. at 190-91 (quoting 26 U.S.C. § 482).

Since *Container*, there have been significant developments in this area that have further modified AL/SA as applied by the federal government. These developments have led a group of experts—including senior officials of the U.S. Treasury, U.K. Inland Revenue, the Fiscal Affairs Division of the OECD, and the Japanese National Tax Administration—to conclude recently that "the arm's length principle and formulary apportionment should not be seen as polar extremes" and that "it is not clear where the arm's length principle ceases and formulary apportionment begins." Arnold and McDonnell, *Report on the Invitational Conference*, 61 Tax Notes at 1381 (December 13, 1993).

The easiest case to show that the federal government uses formulary approaches is the taxation of a U.S. branch of a foreign corporation, such as BBI. Since the Revenue Act of 1921, the Internal Revenue Code has included a provision like 26 U.S.C. § 863(b), which states:

> In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or *formulas of general apportionment* prescribed by the Secretary.

26 U.S.C. § 863(b) (emphasis added).[8]

Regulations for the sale of personal property were promulgated under this section in 1922 and remain essentially unchanged today. *Intel*, 100 T.C. No. 39, BNA Daily Tax Report, June 29, 1993 at K-8 & n.4 (quoting Regs. 62, art. 327 (1922)). Operation of these regulations involves three examples, two of which are pertinent here: Example 1, which applies an arm's length methodology and Example 2, which employs a formulary approach. *See* 26 C.F.R. §§ 1.863-3(b)(2), Example 1 and 1.863-3T(b)(2), Example 2.[9]

Example 1 applies only if the taxpayer "regularly sells part of his output to wholly independent distributors or

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[8] *See* Revenue Act of 1921, ch. 136, 42 Stat. 227, 244-45 (1921). The history of 26 U.S.C. § 863(b) is described in *Intel Corp. v. Comm'r*, 100 T.C. No. 39, BNA Daily Tax Report, June 29, 1993 at K-7—K-8.

[9] Example 3 allows the taxpayer to apply "for permission to base the return upon the taxpayer's books of account." 26 C.F.R. § 1.863-3(b)(2), Example 3.

other selling concerns in such a way as to establish fairly an independent factory or production price," *i.e.*, if there is an independent arm's length transaction. *See* 26 C.F.R. § 1.863-3(b)(2), Example 1. Under rules promulgated by the IRS, it is exceedingly hard to find an "independent factory price" (IFP) under Example 1. The IFP must be derived from sales of the same manufacturer (not unrelated comparables) which are regular and substantial, must involve a wholly independent distributor, must not involve significant income-generating activity of the taxpayer other than manufacturing, and must reasonably reflect the income from manufacturing. Notice 89-10, 1989-1 C.B. 631-32.

In the many instances in which Example 1 is inapplicable, the IRS and the taxpayer generally must apply the method set forth in Example 2. Under Example 2, the annual taxable income attributable to sales of property produced abroad and sold in the United States is first split in half; then, the 50% allocated to manufacturing is apportioned between the U.S. and the foreign jurisdiction based on a property factor, and the 50% allocated to sales is apportioned based on a sales factor. 26 C.F.R. § 1.863-3T(b)(2), Example 2.[10] This method of apportionment is substantially similar to the formulary apportionment employed by California, except that payroll is not a factor and the federal sales factor is more open to manipulation because the location of sales is based on passage of title (a fact wholly within the taxpayer's control) and not on destination. *Compare* 26 C.F.R. § 1.863-3T(b)(2) and § 1.861-7(c) *with* Cal. Rev. & Tax Code § 25135.

Given the constraints on the use of Example 1, it is not surprising that the courts have repeatedly rejected IRS attempts to force taxpayers to use Example 1 rather than the formulary method of Example 2. *See, e.g., Phillips,*

[10] For an explanation of how Example 2 is applied, *see Phillips Petroleum Co. v. Comm'r,* 101 T.C. No. 6 (July 27, 1993), BNA Daily Tax Report, July 28, 1993 at K-5, 1993 U.S. Tax Ct. LEXIS 47,

101 T.C. No. 6, and *Intel,* 100 T.C. No. 39. Thus, for the substantial number of foreign unitary groups engaged in the manufacture of tangible property abroad and its sale in the U.S. through a branch, the federal government applies a formulary method highly similar to California's in the vast majority of cases.

Moreover, it should not be overlooked that the California business of BBI is not just a branch of a foreign corporation—it is a branch of a foreign bank. One of the most important activities of banks is accepting funds on deposit, and thus one of the most important determinants of their income is the allocation of interest expense. The federal government has recognized that because interest is fungible, the interest expense of branches must be apportioned based on a formula that takes into account the worldwide interest expense of the foreign taxpayer, and this method has been applied specifically to U.S. branches of foreign banks. Under 26 U.S.C. § 882(c), deductions allocated to foreign corporations engaged in a U.S. trade or business are apportioned and allocated under regulations prescribed by the Treasury. Under the relevant regulations, BBI's deductible interest expense in the U.S. is calculated based on a formula that compares BBI's U.S. assets to a ratio based on its worldwide assets and liabilities. 26 C.F.R. § 1.882-5(b). This formula is based on the same theoretical underpinnings as WWCR—that it is impossible to allocate income and expense among the parts of a unitary business based on pure AL/SA.

In the case of subsidiaries of a U.S. parent such as Colgate, the situation is slightly more complex. In this context the U.S. generally does not need to apply formulary methods because it has adopted a more extreme solution: Since 1962, the U.S. has considered it entirely legitimate to include the *entire* income of "controlled foreign corporations" such as Colgate's subsidiaries in the annual taxable income of their U.S. parent as a deemed dividend. *See* 26 U.S.C. §§ 951-960. This proposal, originally made by the Kennedy administration, was subsequently modified to include only certain types of income

in the U.S. parent's income currently, and to permit deferral of tax for other types. *See* S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3381-83; Revenue Act of 1962, Pub. L. No. 87-834 § 12, 76 Stat. 960, 1006-27 (1962). But this privilege of deferral, granted for competitiveness reasons, has been steadily eroded and in the most recent tax act has been substantially limited, based on a formula that considers the foreign corporation's passive versus active assets. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 496-501 (August 10, 1993) (to be codified at 26 U.S.C § 956A) In any case, it has not been suggested that the U.S. is breaching an international consensus in currently taxing controlled foreign corporations, and there are recurrent proposals to end deferral altogether with no objection from abroad. *See, e.g.*, Foreign Income Tax Rationalization & Simplification Act of 1992, H.R. 5270, § 201, 102d Cong., 2d Sess. (1992). Clearly, it is much more drastic to allocate the entire income of *all* controlled foreign corporations to the U.S. than to apply WWCR to a domestic parent unitary group, such as Colgate.

Even under the classic arm's length situation, that of a U.S. subsidiary of a foreign parent (such as Barcal), the federal government applies a formulary approach in a large number of cases. This is the result of the reexamination of the regulations under 26 U.S.C. § 482 which was described above (at p. 13), which culminated in the current temporary regulations under that section.

As a preliminary matter, it is necessary to recognize that 26 U.S.C. § 482 itself, which has not been significantly changed since 1928, does not mandate the use of AL/SA or bar the use of WWCR: all it does is state that in the case of affiliated organizations, "the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among such organizations" if necessary to clearly reflect their income. The actual apportionment can be done by pure AL/SA, pure WWCR, or any method in between.

In fact, under the current temporary regulations, if there is no comparable transaction the Secretary may base his § 482 adjustment on the "comparable profits method." This approach constructs a formula based on the profits of comparable, unrelated taxpayers and forces the related parties to adjust their transactions so that their profits fall within the comparable "arm's length" range of profits constructed by the formula. 26 C.F.R. § 1.482-5T.[11] This formula is used in a broad range of cases. Under a "best method rule" provided in the regulations, the formula will be applied when there is no exact comparable to be found, *i.e.*, in the majority of cases in which disputes arise between taxpayers and the IRS. *See* 26 C.F.R. § 1.482-1T(b)(2)(iii); James P. Fuller and Ernest F. Aud, Jr., *The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?*, 6 Tax Notes Int'l 525 (March 1, 1993).[12]

2. *The Federal Government's Use of Formulary Methods In Conjunction With Arm's Length Does Not Violate Its Treaty Obligations*

The federal government thus applies formulary methods, in conjunction with AL/SA, to U.S. branches of foreign corporations (BBI), to foreign subsidiaries of U.S. parents (Colgate), and to U.S. subsidiaries of foreign parents (Barcal). Why, therefore, has there not been an outcry of protest by foreign governments that the U.S. is violating its tax treaties? Because, contrary to petitioners' suggestions, *see* Pet. Br. Barc. 4-6; Pet. Br. Colg. 4-5, the use of formulary methods to apportion income

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[11] The formula relies on "profit level indicators" that include ratios of profit to operating assets, costs (*e.g.*, payroll), and sales, *i.e.*, the same factors California uses. 26 C.F.R. § 1.482-5T(e). *See also* Proposed Regulation § 1.482-6, 58 Fed. Reg. 5310, 5311 (Jan. 21, 1993) (proposing a profit split method based on a formula that incorporates an assets factor).

[12] The use of such formulas in the new temporary and proposed regulations is but an implementation, delayed by over 30 years, of a congressional request to the Treasury Department to develop "formulas" for the application of 26 U.S.C. § 482. *See* H.R. Rep. 2508, 87th Cong., 2d Sess. 18-19 (1962).

and expenses on a worldwide basis, in conjunction with AL/SA, is fully compatible with the treaty obligations of the United States.[13]

First, let us look at the treaty rule on branches, or "permanent establishments," which is Article 7(2) of the U.S. Model Treaty. In *Container*, this Court cited the branch rule as "requir[ing] the Federal Government to adopt some form of 'arm's-length' analysis in taxing the domestic income of multinational enterprises." 463 U.S. at 196. The branch rule states:

> Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

U.S. Model Double Taxation Treaty, art. 7(2) (1981), *reprinted in Model Income Tax Treaties* (Kees van Raad ed., 1983); *cf.* Convention Between the United States and the United Kingdom for Avoidance of Double Taxation, art. 7(2), Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5670, 5675 (U.S.-U.K. Treaty).[14]

How, then, can the U.S. tax permanent establishments under formulary methods, as it does under 26 U.S.C. §§ 863(b) and 882? Three observations can be made in response. First, within the arm's length context established by Article 7(2), the treaty does not forbid the use of all formulary apportionment; it merely mandates the attribution to the branch of the same income that

[13] The following discussion of treaties is based on the analysis contained in Kauder, *The Unspecific Federal Tax Policy of Arm's Length*, 60 Tax Notes 1147.

[14] As discussed by respondent, these provisions govern only the taxing methodology of the federal government and have no applicability to the States. *See* Resp. Br. Barc. 16.

would have been attributed to it under AL/SA. Contrary to Barclays' assertions, it is quite possible for AL/SA and worldwide formulary apportionment to reach the same result—indeed, WWCR is intended to capture those synergies of a unitary business that would have been taken into account by a valid arm's length calculation. Two related businesses, if they were truly dealing with each other at arm's length, would take the synergies that result from their being part of a unitary enterprise into account in allocating the profit of the enterprise between them. Thus, if formulary methods reach the same or similar results as AL/SA in taxing the branch, this would be acceptable under Article 7(2).

Second, Article 7(3) of the U.S. Model Treaty, to which Article 7(2) is subject, expressly requires a "reasonable allocation" of expenses to the branch based on the expenses of the enterprise as a whole. U.S. Model Treaty, art. 7(3); U.S.-U.K. Treaty, art. 7(3), 31 U.S.T. at 5675-76. Thus, the formulary methods of allocating expenses under 26 C.F.R. § 1.882-5 are fully compatible with the U.S. treaty obligations, as the IRS has repeatedly stated. *See* Rev. Rul. 89-115, 1989-2 C.B. 130 (interpreting art. 7(3) of the U.S.-U.K. Treaty); Rev. Rul. 78-423, 1978-2 C.B. 194 (interpreting similar provision in U.S.-Japan Treaty); *see also* Rev. Rul. 85-7, 1985-1 C.B. 188 (same under 26 C.F.R.§ 1.882-5).

Finally, as noted above, formulary apportionment of branch income has been the established practice of the United States since 1922. It is well understood that such an established practice may continue under the AL/SA language of Article 7(2). Indeed, because formulary methods are commonly used by countries that are parties to treaties that require some form of AL/SA, the new OECD model treaty expressly provides:

> Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall pre-

> clude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

OECD Model (Income and Capital) Tax Treaty, Sept. 1, 1992, art. 7(4).[15] Thus, the United States can continue to tax branches of foreign corporations, such as BBI, based on formulary methods, without violating its treaty obligations.

Let us next look at the treaty rule regarding U.S. subsidiaries of foreign corporations, such as Barcal. Article 9(1) of the U.S.-U.K. treaty provides that "[w]here an enterprise of a Contracting State is related to another enterprise" and the relations between the two depart from arm's length, an adjustment to achieve arm's length conditions "may" be made, and in that case, the other state "shall make such adjustment as may be appropriate" to prevent double taxation resulting from the adjustment. U.S.-U.K. Treaty Art. 9(1) and 9(2), 31 U.S.T. at 5677; *cf.* U.S. Model Treaty Art. 9(1) and 9(2).

Louis M. Kauder suggests that Article 9(1) does not, by its terms, require the United States to do anything regarding the taxation of domestic corporations controlled by foreign parents. Kauder, *The Unspecific Federal Tax Policy of Arm's Length*, 60 Tax Notes at 1149-50. The

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[15] For further evidence of the use of formulary in conjunction with arm's length by OECD member nations, *see* Treasury and IRS Report, Appendix E (Report of Agreed Discussions Between the Tax Administrations of France, Germany, the United Kingdom, and the United States) ¶ 3.5, BNA Special Supplement 2, Report No. 70 at S-41 ("In some industries and in some circumstances the use of a formula might be appropriate assuming that the formula attempted to approximate an arm's length result. One [such] area would be global trading . . . ."); *id.*, ¶ 3.6 ("Each one of us has expressed varying levels of support for using carefully tailored formulae in specific situations. The United States sees considerable advantages in this approach in particular cases. Germany and the United Kingdom have agreed to consider the use of such formulae in those cases.").

Senate Foreign Relations Committee, in its report on the Third Protocol of the US UK Treaty, viewed Article 9(1) as "recogniz[ing] the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons." S. Exec. Rep. 5, 96th Cong., 1st Sess. 6 (1979). Thus, Article 9(1) certainly does not forbid the United States from using formulary apportionment, at least within the arm's length context.

In addition, as the *Container* Court pointed out, all of the U.S. treaties generally reserve the right to tax domestic corporations as if the treaty never came into effect. 463 U.S. at 196; *cf.* U.S. Model Treaty, art. 1(3). Thus, the United States could apply any formulary method to domestic subsidiaries of foreign parents, or to United States parents with foreign subsidiaries, without violating any treaty, as long as it is not considered to be taxing the foreign corporations included in the group. *See also* U.S. Model Treaty, art. 9(3) (permitting apportionment under language similar to 26 U.S.C. § 482).

Finally, the U.S.-U.K. treaty contains one unique provision not found in any other United States treaty—the notorious Article 9(4), 31 U.S.T. at 5677, which is the subject of much of the debate in this case. While the Church reservation prevented Article 9(4) from ever applying to California, *see* Resp. Br. Barc. 20-21, it does apply to the federal government, and prevents it from taking into acount the income of a related foreign enterprise in determining the tax liability of its domestic subsidiary. The inclusion of this Article makes it clear that Article 9(1), standing alone, does not prevent the U.S. from using formulary methods. Nor does Article 9(4) prevent the application of WWCR to U.K. subsidiaries of U.S. corporations, which are explicitly excluded from its scope. But even in the case of U.S. subsidiaries of U.K. corporations, the Senate Foreign Relations Committee report on Article 9(4) states that:

> The limitation in Article 9(4) applies only to cases where an allocation is made without regard to any application of the arm's-length standard. Of course, both countries may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's-length basis.

S. Exec. Rep. 5, 96th Cong., 1st Sess. 6 (1979).

Thus, even Article 9(4) does not prevent the federal government from using formulary methods, as long as they reach arm's length results, or it can be established that the related parties were not dealing at arm's length (as will frequently be the case).[16]

In sum, the "one voice" that petitioners contend California must adhere to employs formulary methods akin to California's ubiquitously in its international tax rules, in conjunction with AL/SA. This action by the federal government (and any further federal action along the same lines) does not violate any treaty obligations. And the international pressure on California, compared to the lack of foreign governmental protestations against the federal government, is a reflection of the relative political power of the United States and California, not of the merits of the issue.

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[16] It has been reported that Barclays' own "advance pricing agreement" (APA) with the IRS and the U.K. taxing authorities, relating to a significant portion of its business, is based on taxing "the company's international affairs as one global business" and allocating the profits among jurisdictions based on an undisclosed "formulary methodology." *See IRS Grants Two APAs In Derivative Products Area*, Tax Notes Today, 92 TNT 96-1 (May 6, 1992) (discussing APAs for Barclays and Sumitomo). *See also* U.S. Treasury and IRS, *Joint Statement of Policy and Action Plan on International Tax Compliance* (Dec. 17, 1993), *reprinted in* BNA Daily Tax Report (Dec. 20, 1993), at L-2 (in negotiating APAs, the IRS "has made every effort to agree with the taxpayer on an appropriate methodology, and has applied, in appropriate cases, the methods specified in section 482, variations on those methods, and other methods, such as formulary apportionment").

This report suggests that Barclays acknowledges that formulary methods are appropriate for taxing its worldwide unitary business.

C. California's Formulary Method Does Not Pose More Risk Of Multiple Taxation Than The Arm's Length Method As Applied By The Federal Government

California's use of WWCR also satisfies the remaining prong of the foreign Commerce Clause test—it does not create a heightened risk of international multiple taxation. *See Japan Line*, 441 U.S. at 446-48; *Container*, 463 U.S. at 185. Colgate does not even contest this point, and Barclays' multiple taxation argument is inconsistent both with this Court's precedents and with subsequent developments in the arena of international taxation.

In *Container*, this Court addressed the multiple taxation prong of the foreign Commerce Clause test as applied to WWCR and held that WWCR does not violate this test because arm's length as applied by the federal government, may also lead to double taxation:

> A serious problem, however, is that even though most nations have adopted the 'arm's-length' approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists, the possibility of double taxation also exists. Thus, even if California were to adopt some version of the 'arm's-length approach,' it could not eliminate the risk of double taxation of corporations subject to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

463 U.S. at 191 (footnotes omitted).

Developments since 1983, when *Container* was decided, have dramatically demonstrated the correctness of

these observations. The potential for double taxation under AL/SA results from the basic theoretical flaw of AL/SA—the fact that it does not provide a uniform or consistent way of making allocations where comparables are not available. *See* discussion at pages 8-12, *supra*. International double taxation is the likely outcome of AL/SA because one cannot expect foreign taxing authorities to respect allocations which the U.S. courts admit are based on a "best estimate" slicing of the shadow, or on economically inappropriate "comparables."

That multiple taxation is as likely under AL/SA (as applied by the federal government) as under WWCR is indicated by the reactions to the temporary regulations of foreign interested parties, many of whom are *amici* in this case in support of petitioners. They have vigorously objected to the most recent federal AL/SA plus formulary approach based on their contention that it will lead to international double taxation, and that the temporary regulations do not comport with the arm's length standard. Thus, the International Chamber of Commerce has stated unequivocally:

> We object to this new formulation both on general grounds, in view of the likely damaging consequences for international trade and investment . . . and, more specifically, because within the temporary regulations it is evidently designed to confer arm's length validity on a method—the comparable profits method—which in fact does not accord with the arm's length principle.

Letter of International Chamber of Commerce of 4/22/93, ¶ 11, *reprinted in International Chamber of Commerce Attacks New Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 113-24 (May 27, 1993). The International Chamber of Commerce went on to assert that the federal government's methodology "is contrary to the arm's length principle and will inevitably lead to double taxation. *Id.* at ¶ 21.[17]

[17] The Korean Ministry of Finance has made the same point by complaining that "the revised regulations are still not fully consistent with the internationally accepted arm's length standard." Letter of Rah-Yong Uhm of 8/9/93, Director General for Tax Affairs, Ministry of Finance, Republic of Korea, *reprinted in Korean Finance Ministry Comments on Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 181-49 (Aug. 31, 1993). The Representative of German Industry and Trade has likewise stated that "[w]e continue to have fundamental, grave objections to the temporary intercompany transfer pricing regulations" on the grounds that they lead to incorrect results and "contradict[] the Arm's Length Standard." Letter of Christof S. Klitz of 7/19/93, *reprinted in German Industry Rep Takes Aim At Proposed Regs.*, Tax Notes Today, 93 TNT 163-64 (Aug. 5, 1993). Keidanren, the Japan Federation of Economic Organizations, asserts that the principal innovation of the temporary regulations "is not in accordance with the international rule of transfer pricing taxation . . . . [which] places great emphasis on an arm's length pricing system among entities." Letter of Tsunekazu Sakano of 7/13/93, ¶ 1, *reprinted in Keidanren Urges IRS to Take Another Look at Proposed Regs.*, Tax Notes Today, 93 TNT 158-24 (July 29, 1993).

It is thus clear that AL/SA, as applied by the federal government, is at least as likely to lead to international double taxation as WWCR. As the Court has already held, "it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." *Container*, 463 U.S. at 193 (citation omitted).

II. CALIFORNIA'S FORMULARY METHOD DOES NOT VIOLATE THE DUE PROCESS CLAUSE, AS IT IMPOSES NO HEAVIER BURDEN ON MULTINATIONAL CORPORATIONS THAN IS IMPOSED UNDER CURRENT FEDERAL LAW

Barclays' due process argument ignores the extensive requirements imposed on foreign-based multinationals under federal law, which have not been challenged on due process grounds. While California only needs worldwide payroll, asset, and sales data, and net worldwide income, the federal government needs a much broader range of information on the business of the foreign-based enterprise to implement AL/SA. In 1989 and

1990, Congress amended the Internal Revenue Code to authorize the Treasury to prescribe broad record keeping requirements for corporations that are 25% foreign owned, such as Barcal, and for foreign corporations engaged in a U.S. business, such as BBI, in both cases with penalties for noncompliance. *See* Pub. L. No. 101-239, § 7403, 103 Stat. 2358 (1989) (amending 26 U.S.C. § 6038A); Pub. L. No. 101-508, § 11315, 104 Stat. 1388-456 (1990) (adding 26 U.S.C. § 6038C).[18]

The following is just an illustrative list of the records required to be kept by foreign-owned corporations and foreign corporations under regulations promulgated to implement these sections in 1991: original entry books and transaction records relevant to transactions with the U.S. subsidiary; records from which "material profit and loss statements" can be constructed, including an explanation of any differences with United States generally accepted accounting principles (GAAP); "all documents relevant to establishing the appropriate price or rate for transactions" between the U.S. subsidiary and "any foreign related party"; all relevant "[f]oreign country and third party filings"; "[o]wnership and capital structure records"; and "[r]ecords of loans, services, and other non-sales transactions." 26 CFR § 1.6038A-3(c)(2).[19] The foreign party must deliver those documents to the Internal Revenue Service, or give the Service access to the records in the U.S., within 60 days of a request, and provide a translation of the records within 30 days of an IRS request. 26 CFR § 1.6038A-3(f). A substantial portion of the records must be created if they do not exist. 26 CFR § 1.6038A-3(c)(1).

Compared to these broad requirements, the burden imposed by California's rules, subject as they are to a "rea-

[18] Until 1989, it was difficult for the IRS to obtain the required information from foreign entities. *See, e.g., U.S. v. Toyota Motor Corp.*, 561 F.Supp. 354 (C.D. Cal. 1983); *U.S. v. Toyota Motor Corp.*, 569 F.Supp. 1158 (C.D. Cal. 1983).

[19] *See also* the elaborate rules for determining what is a "material profit and loss statement" under 26 CFR § 1.6038A-3(c)(3)-(6).

sonably approximate" standard, pales to insignificance. Of course, "while Congress has plenary power to regulate commerce . . . it does not similarly have the power to authorize violations of the Due Process Clause." *Quill Corp. v. North Dakota*, 112 S. Ct. 1904, 1909 (1992). If this Court strikes down California's WWCR as unconstitutional on due process grounds, it jeopardizes the constitutionality of significant federal transfer pricing enforcement powers as well, which Congress has judged necessary to ensure that foreign-owned U.S. corporations pay their fair share of taxes.

The same analysis applies with even greater force to Barclays' argument that California's rules are too vague and arbitrary, despite being subject to court supervision. *See* Pet. Br. Barc. 47 (citing Cal. Admin. Code Tit. 18 § 25137-6).[20] It has been commonplace in litigation under 26 U.S.C. § 482 for courts to complain that in the absence of specific standards to guide them when there are no comparables, and given the extremely broad language of the statute, the IRS and the courts are required to reach decisions that are essentially arbitrary.[21] Perhaps the classic statement comes from a case decided in favor of the federal government, where the court's task was likened to "making bricks without straw." *Du Pont*, 608 F.2d at 461 (citation omitted) (Nichols, J. concurring). Judge Nichols went on to elaborate:

> [T]he Congressional request to write regulations to govern these § 482 reallocations is one sentence long: 'it is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority [§ 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.' Clearly the result of our decision is that

[20] It is worth noting that California's Regulation 25137-6, the subject of Barclays' attack (*see* Pet. Br. Barc. 47-49), is derived from IRS regulations. *See* 26 C.F.R. § 1.964-1 (1992). If § 25137-6 is invalid, the federal regulation is similarly suspect.

[21] *See* the cases cited above in Part I.A; *see also* J.A. 829 (expert testimony of David R. Tillinghast).

> this has not been done . . . and it remains in the almost if not wholly unreviewable discretion of the Treasury, as it was when the suggestion was made.

Id. at 462 (internal citation omitted).

This lack of guidelines persisted until the temporary regulations were issued in 1993. However, the federal government's discretion under 26 U.S.C. § 482 has never been attacked on due process grounds, because (as in California) the courts were available to ensure that it was not applied in an arbitrary and capricious fashion, and in fact the courts have repeatedly struck down IRS assessments under 26 U.S.C. § 482.[22] The same analysis applies to California's analogous provisions. If this Court strikes down California's WWCR on due process grounds, it would cast a heavy shadow of doubt on the hundreds of cases that are currently pending under the federal law that preceded the issuance of the temporary regulations in 1993.

CONCLUSION

The judgments below should be affirmed.

Respectfully submitted,

REUVEN S. AVI-YONAH
1525 Massachusetts Avenue
Cambridge, MA 02138
(617) 496-8262

RICHARD RUDA *
Chief Counsel
LEE FENNELL
STATE AND LOCAL LEGAL CENTER
444 North Capitol Street, N.W.
Suite 345
Washington, D.C. 20001
(202) 434-4850

* *Counsel of Record for the* Amici Curiae

January 19, 1994

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[22] *See, e.g.*, cases cited above in Part I.A. *Cf. Panhandle Oil Co. v. Mississippi ex rel. Knox*, 277 U.S. 218, 223 (1928) (Holmes, J., dissenting) ("The power to tax is not the power to destroy while this Court sits."), *overruled by Alabama v. King & Boozer*, 314 U.S. 1 (1941).

Supreme Court, U.S.
FILED
JAN 19 1994
OFFICE OF THE CLERK

Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY SENATORS BYRON L. DORGAN, TED STEVENS, FRANK H. MURKOWSKI, JUDD GREGG, AND ROBERT C. SMITH

Charles Rothwell Nesson
1575 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4609
Counsel of Record

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QUESTION PRESENTED

When the United States Senate has carefully studied and unambiguously rejected a treaty provision that would bar the States from employing a particular method of corporate tax accounting for foreign corporations, should the Judiciary nevertheless prevent a State from using this method of accounting under the dormant authority of the Foreign Commerce Clause?

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MISCELLANEOUS:

124 Cong. Rec. 18402-18430, 18651-18670 (1978) 5

124 Cong. Rec. 18670, 18709-18712 and 19076-19078 (1978) 5

Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY SENATORS BYRON L. DORGAN, TED STEVENS, FRANK H. MURKOWSKI, JUDD GREGG, AND ROBERT C. SMITH

INTEREST OF AMICI

Amici are members of the United States Senate. This case presents this Court with issues involving the proper roles of

the Executive Branch and the Senate in establishing United States policy through the treaty mechanism. Amici, as members of the United States Senate, have a unique and vital interest in these questions and, in particular, the significance to be attached to the actions of the United States Senate in declining to give its advice and consent to a treaty presented to it by the Executive Branch, as required for ratification by the Constitution of the United States.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of Respondent Franchise Tax Board, State of California. The consent of counsel to the filing of this brief has been obtained and has been or will be filed with the Clerk of this Court in due course.

SUMMARY OF ARGUMENT

The United States Senate was asked to give its advice and consent to a tax treaty between the United States and the United Kingdom which would have prohibited the States from using the unitary method of tax accounting with respect to multinational businesses domiciled in the United Kingdom. After intensive consideration, the Senate refused to give its advice and consent to the Treaty with this prohibition. This refusal was made in fulfillment of the Senate's constitutional role as a protector of State sovereignty. With all due respect and deference to the wisdom which this Court possesses and exhibits, it is respectfully submitted that this Court should not intervene in this matter so as to overrule the judgment made by members of the Senate.

ARGUMENT

THE SENATE'S REFUSAL TO CONSENT TO A TREATY IS AN ACT OF CONSTITUTIONAL SIGNIFICANCE

The cause here is the right of States of the United States to choose the mode of tax accounting to be used in the raising of state revenue. At issue also is the constitutional integrity of the United States Senate.

The unitary method of tax accounting is an integrated, conceptually fair basis of taxation which seeks to negate the intense complexities of intercorporate international tax accounting embodied in the "arm's-length" method. The arm's-length method treats each legal corporate entity as if it were real, while ignoring the identity of the whole enterprise. The unitary method identifies the income of the whole and then apportions that income according to the proportionate contribution of the taxing State.

The constitutional integrity of the United States Senate is at stake because of the risk that the Supreme Court of the United States will ignore the Senate's constitutionally given power to play a role in the balance to be cast between state and local power on the one hand and foreign policy on the other.[1] The Constitution empowers the Senate, as part of the

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[1] In prior decisions, this Court has exhibited its sensitivity to the Senate's role in our federal structure. For example, in *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) at 551-552, this Court stated:

> The extent to which the structure of the Federal Government itself was relied on to insulate the interests of the States is evident in the

(continued...)

Congress, to regulate commerce, interstate and foreign, and to advise and consent in the making of treaties of agreement with foreign nations.

In the circumstances of the present case, the Executive Branch sought the advice and consent of the Senate to a treaty negotiated with Great Britain about terms of trade. High in priority among the provisions sought by Great Britain was agreement by the United States to impose a ban upon States from using unitary methods of tax accounting. The treaty would have imposed the "arm's-length" method on all of the States of the United States by the constitutional supremacy of treaties over domestic law.[2] Great Britain, in these

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[1](...continued)
views of the Framers. James Madison explained that the Federal Government "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments." [citation omitted] . . . "it was a favorite object in the Convention" to provide for the security of the States against federal encroachment and that the structure of the Federal Government itself served that end. [citation omitted] . . . equal representation of the States in the Senate, which he saw as "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an instrument for preserving that residuary sovereignty." [citation omitted] . . . "the residuary sovereignty of the States [is] implied *and secured* by that principle of representation in one branch of the [federal] legislature" (emphasis added). [citations omitted] . . . the Framers chose to rely on a federal system in which special restraints on federal power over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.

[2] U.S. Const., art. VI, § 2.

negotiations, may be seen as speaking for the international multinational corporate and banking interests that want to take advantage of United States markets and natural resources without having to account for any of the benefits which flow between local activities and the rest of their global enterprises.

The Senate intensely considered the request of the Executive Branch for its advice and consent to this treaty.[3] The Senate responded, rejecting the treaty as written, consenting to its ratification only without the ban on the use by the States of the unitary method of accounting.[4] The Senate continued to attend to the issue intensively until the problem was significantly resolved through political channels in the mid-1980's.[5]

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[3] 124 Cong. Rec. 18402-18430, 18651-18670 (1978).

[4] 124 Cong. Rec. 18670, 18709-18712 and 19076-19078 (1978).

[5] Various committees of the United States Congress have held hearings on the issues of state taxation including the use by the states of unitary reporting. The hearings listed below indicate the intensity, both in depth and time of consideration:

> Report of the Subcommittee on State Taxation of Interstate Commerce of Committee on Finance on S. 1245 (Mathias) and S. 2092 (Magnuson) (490 pages); Committee on Ways and Means, 95th Congress, 1st Sess., Recommendations of the Task Force on Foreign Source Income (Comm. Print 1977); Senate Committee on Foreign Relations, Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland as Amended, S. Doc. No. 5, 96th Cong., 1st Sess. (1979) (150 pages); Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, 1977: Hearings Before the Senate Committee on Foreign Relations, 96th Cong., 1st Sess. (1977) (496 pages); State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate
> (continued...)

Now the multinational corporate interests try a different tack, here direct to the United States Supreme Court for a ruling from the Justices that unitary approaches to taxation should be banned under the authority of the Foreign Commerce Clause where multinational corporations are concerned. The premise of Petitioners' claim is that Congress has not spoken on the issue of a ban on States wishing to use other than arm's-length accounting, that the Federal Government must speak on this issue with "one voice," and therefore the Judiciary should dictate the arm's-length method under the dormant authority of the Foreign Commerce Clause. But to say, in this situation, either that the Congress has not expressed itself or that the situation requires one and only one approach, blinks reality.[6] Because the Senate has spoken in its constitutional voice,[7] the California tax is permissible.

To grant the petitioners' request would constitute an institutional insult to the Senate. The Executive Branch invoked Senatorial process, and does not assert the inconsequence of resulting Senatorial action. Since the Senate's rejection of the ban, the Executive has repeatedly

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[5](...continued)
Comm. on Finance, 96th Cong., 2d Sess. (1980) (982 pages); Unitary Taxation, 1984: Hearings Before the Subcomm. on International Economic Policy of the Senate Foreign Relations Comm., 98th Cong., 2d Sess. (1984) (445 pages); Interstate Taxation, S. 2173: Hearings Before the Senate Committee on the Judiciary, 95th Cong., 1st and 2d Sess. (1977-1978) (957 pages).

[6] *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1, 11-12 (1986), establishes that rejection of treaty provisions can have legal significance for Foreign Commerce Clause analysis.

[7] U.S. Const., art. II, § 2, cl. 2.

recognized the Senate's position and has made no effort to circumvent it. Instead, conflicts over tax accounting methods have been further negotiated through diplomatic and political processes.[8] California changed its law substantially in 1986,[9]

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[8] The Executive Branch negotiated the United States/United Kingdom Tax Convention with the United Kingdom in 1975. In transmitting the proposed treaty to the Senate for its advice and consent, the Executive Branch noted, "A second new provision is found in paragraph 4 of Article 9 (Associated Enterprises). This provision represents the *first attempt* to bind State and local taxing authorities by a substantive provision of the treaty (other than non-discrimination)." (Emphasis added). Letter of Submittal, June 8, 1976, 3 Tax Treaties Reporter (CCH) ¶ 10,938. The Executive Branch then negotiated the Third Protocol to the Treaty to reflect the action of the Senate. In a summary of the Protocol prepared for the Senate Foreign Relations Committee, the first modification is described by the Executive Branch as follows:

> "In conformity with the Church reservation, the protocol makes Article 9(4) of the proposed treaty, which restricts the use of the worldwide combination/unitary method of apportioning income, inapplicable to state or local governments. The provisions of Article 9(4) would continue to apply, however, to the United States and United Kingdom governments." Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended: Report of the Committee on Foreign Relations, United States Senate; S. Doc No. 5, 96th Congress, 1st Sess. (1979)

In 1979 in response to a question by Senator Church, Assistant Secretary of Treasury for Tax Policy, Donald C. Lubick, submitted the following explanation to the Committee on Foreign Relations of the United States Senate as to why state taxes were not included by the administration in its own Model Income Tax Treaty:

> "These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes." *International Tax Treaties: Hearing before the Senate Comm. on Foreign Relations*, 96th Cong., 1st Sess. (June 6, 1979), p. 112 (statement of Donald C. Lubick).

(continued...)

with refinements in 1993,[10] which led the Executive Branch, through the Solicitor General, to suggest to this Court the wisdom of declining to hear the present case and refraining

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[8](...continued)

During consideration of the proposed Unitary Tax Repealer Act in 1985, Roger Mentz, Assistant Secretary of the Treasury for Tax Policy, testified for the Executive Branch as follows:

> "I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah, and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the *successful* operation of the Federal system. . . . We have not . . . reached the end of the road with respect to this issue. . . . *We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time.*" *Review of Unitary Method of Taxation: Hearing Before the Subcommittee of Finance on Taxation and Debt Management of the Committee on Finance on S. 1113 and S. 1974*, 99th Cong., 2d Sess. (September 29, 1986), p. 71. (Emphasis added).

In transmitting the 1973 Income Tax Convention with the Union of Soviet Socialist Republics to the Senate Foreign Relations Committee, the State Department made the following statement regarding "Taxes Covered" in the Technical Explanation: "The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, *in keeping with past U.S. policy the taxes of the state and local governments of the United States* are excluded from the scope of the Convention, except for purposes of Article X (Nondiscrimination)." (Emphasis added). 3 Tax Treaties Reporter (CCH) ¶ 10,630 p. 44,029.

[9] Ch. 660, Cal. Stats. 1986.

[10] Ch. 881, Cal. Stats. 1991.

from taking a position in support of Petitioners on the merits.[11]

We in the Senate do not understand the Supreme Court of the United States to have been anything but sensitive in the past to the balance and separation of powers among the Federal branches and the States in respect to judicial interpretation of the Foreign Commerce Clause. The Supreme Court's opinion in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), sets the framework with a remarkably direct and able dissection of the foreign commerce problem, holding that California had no obligation under the Foreign Commerce Clause to employ the "arm's-length" method, as long as application of its unitary approach is fair.

Yet it is incumbent upon us, not as supplicants only before a great court, but as friends of the court asserting equal stature for the institution of the Senate and equal strength in the balance of the power of our Nation, to say that the Federal Government does not speak, need not speak, and should not be made to speak with the "one voice" to impose the "arm's-length" method of taxation upon the separate States.

We assert the constitutional entitlement of the United States Senate to a role of principal in the making of international treaty arrangements. We ask the Supreme Court

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[11] Brief of United States, October 7, 1993, *Barclays Bank PLC v. Franchise Tax Board*, p. 10-11.

of the United States not to allow our role and process to be ignored and overridden.

Dated: January 19, 1994

Respectfully submitted,

Charles Rothwell Nesson
1575 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4609
Counsel of Record